Docket for 03-932

(26)

No. 03-932
Title: Dura Pharmaceuticals, Inc., et al., Petitioners
v.
Michael Broudo, et al.
Docketed: January 5, 2004
Lower Ct: United States Court of Appeals for the Ninth Circuit
Case Nos.: (01-57136)
Decision Date: August 5, 2003
Rehearing Denied: September 29, 2003
Questions Presented

~~Date~~	~~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~~~~~
Dec 24 2003	Petition for a writ of certiorari filed. (Response due February 4, 2004)
Feb 4 2004	Motion for leave to file amicus brief filed by Securities Industry Association.
Feb 4 2004	Brief of respondents Michael Broudo, et al. in opposition filed.
Feb 17 2004	Reply of petitioners Dura Pharmaceuticals, Inc., et al. filed. (Distributed)
Feb 18 2004	DISTRIBUTED for Conference of March 5, 2004.
Mar 8 2004	The Solicitor General is invited to file a brief in this case expressing the views of the United States.
May 28 2004	Brief amicus curiae of United States filed.
Jun 8 2004	DISTRIBUTED for Conference of June 24, 2004.
Jun 10 2004	Supplemental brief of respondents Michael Broudo, et al. filed. (Distributed)
Jun 18 2004	Supplemental brief of petitioners Dura Pharmaceuticals, Inc., et al. filed. (Distributed)
Jun 28 2004	Motion for leave to file amicus brief filed by Securities Industry Association GRANTED.
Jun 28 2004	Petition GRANTED.
Jul 19 2004	Extension of time within which to file the joint appendix and petitioners' brief on the merits to and including September 13, 2004.
Sep 13 2004	Brief amici curiae of American Institute of Certified Public Accountants filed.
Sep 13 2004	Brief amicus curiae of Chamber of Commerce of the United States filed.
Sep 13 2004	Brief amicus curiae of United States filed.
Sep 13 2004	Brief amicus curiae of Washington Legal Foundation filed.
Sep 13 2004	Brief amici curiae of Securities Industry Association and the Bond Market Association filed.
Sep 13 2004	Brief amicus curiae of Technology Network filed.
Sep 13 2004	Joint appendix filed.
Sep 13 2004	Brief of petitioners Dura Pharmaceuticals, Inc., et al. filed.
Sep 13 2004	Brief amicus curiae of Broadcom Corporation filed.
Sep 13 2004	Brief amicus curiae of Merrill Lynch & Co., Inc. filed.
Sep 17 2004	Extension of time within which to file respondents' brief on the merits to and including November 17, 2004.
Nov 5 2004	Consent to the filing of amicus briefs in support of either party received from counsel for the respondents.
Nov 12 2004	SET FOR ARGUMENT ON Wednesday, January 12, 2005.
Nov 12 2004	CIRCULATED.

Nov 12 2004	Brief amici curiae of National Association of Shareholder and Consumer Attorneys, et al. filed. (Distributed)
Nov 15 2004	Brief amicus curiae of New Jersey Department of the Treasury and its Division of Investment filed. (Distributed)
Nov 17 2004	Brief amicus curiae of Regents of the University of California filed. (Distributed)
Nov 17 2004	Brief of respondents Michael Broudo, et al. filed. (Distributed)
Nov 17 2004	Letter proposing a lodging received from counsel for the respondents.
Nov 17 2004	Brief amicus curiae of North American Securities Administrators Association, Inc. filed. (Distributed)
Nov 17 2004	Brief amici curiae of City of New York Pension Funds, et al. filed. (Distributed)
Nov 17 2004	Brief amicus curiae of James J. Hayes filed. (Distributed)
Nov 18 2004	Motion of the Acting Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
Dec 13 2004	Motion of the Acting Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
Dec 14 2004	Record received from U.S.C.A. 9th Circuit. (1 envelope)
Dec 22 2004	Reply of petitioners Dura Pharmaceuticals, Inc., et al. filed. (Distributed)
Dec 22 2004	Reply of petitioners Dura Pharmaceuticals, Inc., et al. filed. (Distributed)
Dec 30 2004	Record received from the U.S.D.C. - Southern Dist. of California. (2 boxes)
Jan 12 2005	Argued. For petitioners: William F. Sullivan, San Diego, Calif.; and on behalf of the United States, as amicus curiae, Thomas G. Hungar, Deputy Solicitor General, Department of Justice, Washington, D.C. For respondents: Patrick J. Coughlin, San Francisco, Calif.

Supreme Court, U.S.
FILED

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No. 03-

IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price.

STATEMENT PURSUANT TO RULE 29.6

Pursuant to Supreme Court Rule 29.6, petitioner Dura Pharmaceuticals, Inc. states that on December 31, 2001 Dura Pharmaceuticals, Inc. merged with and into Elan Pharmaceuticals, Inc., a privately held Delaware corporation, which is a wholly-owned subsidiary of Elan Corporation, plc. a publicly-traded entity.[1]

1. In the caption page to its opinion, 339 F.3d 933 (9th Cir. 2003), the Ninth Circuit inadvertently listed certain non-parties as defendants/appellees. Merrill Lynch and Co./Merrill Lynch, Pierce, Fenner and Smith, Inc. were omitted by the plaintiffs/respondents from the Consolidated Amended Complaint and did not appear before the court of appeals. Nissan Motor Co., a Japanese corporation, was never a party in this case.

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Petitioners respectfully pray that a writ of *certiorari* issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The order of the district court granting petitioners' motion to dismiss the second amended complaint with prejudice is not reported, but is reprinted in the Appendix ("Pet. App.") at 18a-51a. The Ninth Circuit opinion (Archer, J., joined by Reinhardt and Pregerson, JJ.)[2] reversing the district court is published at 339 F.3d 933 (9th Cir. 2003) and reprinted at Pet. App. 1a-17a.

STATEMENT OF JURISDICTION

The court of appeals entered its opinion and order on August 5, 2003. A timely petition for rehearing and rehearing *en banc* was filed. On September 29, 2003, the panel, before Pregerson, Reinhardt, and Archer, JJ., denied the petition for rehearing and the suggestion for rehearing *en banc* was rejected. (Pet. App. at 52a-53a). This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78a, *et seq.*, relevant to this petition, including the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), P.L. 104-67, 1995 HR 1058, are reproduced at Pet. App. 54a-55a.

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2. The Honorable Glenn L. Archer, Jr., Senior Circuit Judge, United States Court of Appeals for the Federal Circuit, sitting by designation.

STATEMENT OF THE CASE

The Ninth Circuit's decision acknowledges that it conflicts with those from other Circuits. The Ninth Circuit allowed this case to proceed on a bare allegation that a security's price was "inflated," without showing proof of a subsequent decline in price that related to the alleged "inflation." Other Circuits, the Ninth Circuit acknowledged, require proof of loss causation: "a corrective disclosure followed by a stock price drop." (Pet. App. 9a n.4.) This Court should grant review to resolve that acknowledged conflict.

1. Petitioner Dura Pharmaceuticals, Inc. ("Dura") was a San Diego-based developer and marketer of prescription pharmaceutical products for the treatment of allergies, asthma, and related respiratory conditions. The individual petitioners herein held various management and/or director positions with Dura. Respondents are investors who purchased shares of Dura between April 15, 1997 and February 24, 1998 (the "Class Period").

2. On February 24, 1998 Dura announced that it expected a revenue shortfall for the upcoming full year due to anticipated slow pharmaceutical sales, increased competition and a need to increase Dura's sales force. The announcement said nothing about Albuterol Spiros, Dura's delivery device for asthma medication, which was in development in coordination with the United States Food and Drug Administration ("FDA"), and not yet FDA-approved. Following this announcement, Dura's stock dropped from $39.125 on February 24, 1998 to $20.75 on February 25, 1998, a 47% one-day loss.[3]

3. Plaintiffs rely upon intra-day trading highs and lows in Dura common stock to enhance their allegations. On February 24, 1998 Dura's shares closed at $38.125. Supplemental Excerpts of Record (Vol. 2) ("SER"), 79, Exh. L (Dura common stock price history). On February 25, 1998 Dura's shares closed at $23.938. *Id.*

3. On November 3, 1998, nearly nine months after Dura's February 24, 1998 announcement and the concurrent loss in stock price, Dura announced that the FDA did not approve Albuterol Spiros due to issues of electro-mechanical reliability and the need for additional clinical trials.[4]

4. Respondents filed a Consolidated Amended Complaint ("CAC") on October 7, 1999. Respondents allege that petitioners made materially false statements during the Class Period regarding, inter alia, the prospects of Albuterol Spiros. Respondents did not seek to recover losses associated with the November 3 announcement concerning Albuterol Spiros. Rather, respondents sought to recover for the 47% decline in price that followed the February 24 announcement of an anticipated prospective revenue shortfall. On July 12, 2000, the district court granted petitioners' motion to dismiss the CAC without prejudice. At such time, the district court admonished respondents that failure to comply with the requisite pleading standards may subject their complaint to dismissal with prejudice.

5. On November 2, 2001, the district court granted petitioners' motion to dismiss the Second Amended Complaint ("SAC") with prejudice and entered judgment in petitioners' favor. (Pet. App. 51a) The district court found, in relevant part, that respondents' allegations concerning Albuterol Spiros were insufficient to state a claim because

4. Dura's share price declined somewhat following the November 3 announcement, from $12.375 to $9.75. SER, 79, Exh. L. Within twelve trading days, however, the stock price recovered to $12.438, and within ninety days it closed at $14.00 per share. *Id.*

plaintiffs failed to plead the requisite "loss causation."[5] Specifically, the district court focused on the end of the Class Period and Dura's announcement on February 24, 1998 which was followed by a stock price decline:

> The SAC does not allege that the February 24, 1998, announcement contained any negative information about Albuterol Spiros. Rather, Dura did not announce that the FDA would not approve Albuterol Spiros until nine months later, in November 1998. (SAC ¶ 136.) The SAC does not contain any allegations that the FDA's non-approval had any relationship to the February price drop. Accordingly, the SAC does not explain how the alleged misrepresentations and omissions regarding Albuterol Spiros "touched" upon the reasons for the decline in Dura's stock price. Rather, the decline in Dura's stock price was the result of an expected revenue shortfall.

(Pet. App. 40a). The district court noted that because the February 24 announcement did not mention the Albuterol Spiros device, no omissions or misrepresentations about the device could be said to have caused the decline in price. The district court expressly rejected respondents' contention that they had properly pleaded loss causation because they alleged that the stock price on the date of purchase was inflated because of the misrepresentations or omissions and

5. In granting petitioners' motion to dismiss with prejudice, the district court also found that respondents failed to allege particularized facts establishing that any material statements were false or misleading when made, and failed to allege particularized facts establishing a strong inference of scienter.

they would not have purchased the stock had they known about the petitioners' wrongdoing. (Pet. App. 40a).

6. On respondents' appeal, the Ninth Circuit reversed in an opinion remarkable for its admitted conflict with well-established and authoritative decisions of other federal Circuits that have addressed the identical issue. The court of appeals acknowledged, consistent with the district court's reasoning, that the loss causation element is satisfied in the Ninth Circuit if "the plaintiff shows that 'the misrepresentation touches upon the reasons for the investment's decline.'" (Pet. App. 8a). But the Ninth Circuit found the "touches upon" language ambiguous enough to ignore the absence of any causal link between the Albuterol Spiros allegations and the Dura stock price decline following the February 24 announcement. The court of appeals allowed respondents to proceed on a price inflation theory unrelated to the actual February 24 revenue announcement and price decline.

According to the Ninth Circuit, in a fraud-on-the-market case, plaintiffs establish loss causation if they plead that the stock price on the date of purchase was inflated because of the misrepresentation. The court of appeals concluded that it is not necessary that a market price drop actually occur in order to establish loss causation. According to the court of appeals, to withstand a motion to dismiss, a plaintiff need only allege: (1) that the price at the time of purchase was overvalued; and (2) sufficient identification of the cause for the overvaluation. (Pet. App. 10a).[6]

6. In addition to its holding regarding loss causation, the court of appeals also vacated and remanded the district court's finding of no scienter, instructing the district court to consider the plaintiffs' allegations of scienter collectively, rather than separately. The court of appeals further found that the district court abused its discretion

(Cont'd)

REASONS FOR GRANTING THE PETITION

Two sound reasons for review exist. First, the Ninth Circuit's holding on loss causation contradicts (as the Ninth Circuit itself recognized, Pet. App. 9a n.4) decisions in the Eleventh, and Third Circuits,[7] in that it substitutes price inflation for the Congressionally mandated proof of loss. And, as will be detailed herein, the Ninth Circuit's interpretation (also recently supported by the Eighth Circuit) is also in conflict with decisions in the Second, Fifth and Seventh Circuits. Each of these other Circuits requires a plaintiff to plead and prove a causal connection between the alleged fraud and actual loss in stock price. Second, the Ninth Circuit's interpretation of loss causation cannot be reconciled

(Cont'd)
in denying leave to amend the SAC. (Pet. App. 14a-16a). Because the court of appeals held that respondents had sufficiently pleaded loss causation by alleging artificial inflation at the time of purchase, respondents' potential amendments to the SAC will not affect the loss causation issue. This petition concerns whether the Ninth Circuit's interpretation of loss causation is correct, and that question is squarely presented now. Because the majority of securities cases settle before reaching trial or a final disposition, refusal to review this issue based solely on the procedural posture of the case significantly decreases the chances that the issue will ever be resolved. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 525, 569 (Feb. 1991) (settlement rate for securities class actions is much higher than for civil litigation generally). Review by this Court therefore ought not be deferred until any later time. *See United States v. General Motors Corp.*, 323 U.S. 373, 377 (1945); *Gillespie v. United States Steel Corp.*, 379 U.S. 148, 153 (1964).

7. *See Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000); *Robbins v. Kroger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997).

with the legislative history and plain language of the Reform Act. Notably, the Ninth Circuit's theory of loss causation is not practically viable in light of the Reform Act's explicit limitation on damages, which defines a plaintiffs' loss in terms of a post-transaction decline in stock price.

I. The Ninth Circuit Has Decided An Important And Recurring Issue Of Federal Securities Law – Loss Causation – In A Manner That Creates A Real And Intolerable Conflict Among The Circuits

The requirement of "loss causation" derives from the common law tort concept of "proximate causation" and, as such, has developed exclusively out of case law. The Reform Act codified that requirement. At least as early as 1981, in the seminal case of *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part*, 459 U.S. 375 (1983), the loss causation requirement was found to be satisfied in securities fraud cases only if the misrepresentation touches upon the reasons for the investment's decline in value.[8] The majority of Circuits that have explicitly addressed loss causation, including the Second, Third, Seventh, and Eleventh, have adopted an interpretation similar to that set forth in *Huddleston*, while the Eighth and Ninth Circuits have applied a very different rule.

8. As the *Huddleston* court noted, "absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission." *Huddleston*, 640 F.2d at 549.

A. Most Circuits Apply A Loss Causation Rule Different From That Applied By The Ninth Circuit Here

1. The Eleventh Circuit

The Eleventh Circuit has expressly acknowledged the conflict that exists among the Circuits regarding the interpretation and application of the loss causation requirement. In *Robbins v. Kroger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997), the court of appeals addressed loss causation in a fraud-on-the-market case, with facts similar to those at issue here, wherein the misrepresentation was not disclosed to the public until more than one year after the drop in stock price. In *Robbins*, the plaintiffs presented evidence that an independent accounting firm made fraudulent statements about a company's financial status, which misled investors and artificially inflated the price at which investors purchased the company's stock. *Id.* at 1445-46.[9] The drop in stock price, however, occurred more than one year before the fraud was disclosed. *Id.* at 1445.

In a detailed analysis of loss causation, the Eleventh Circuit cited to decisions in both the Eighth and Ninth Circuits, acknowledging that in fraud-on-the-market cases, some courts have held that loss causation is established if the plaintiff can show that the price of stock on the date of purchase was inflated because of a misrepresentation. *Id.* at 1448 (citing *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) and *In Re Control Data Corp. Securities*

9. To show that they relied on the accountant's misrepresentations, plaintiffs employed the fraud-on-the-market theory which presumes that the plaintiff class relied on an open, well-developed, and efficient market in purchasing their stock. *Id.* at 1446.

Litigation, 933 F.2d 616, 619-20 (8th Cir. 1991)). The court of appeals, however, expressly rejected the reasoning adopted in these Circuits, finding that their use of a presumption of reliance under the fraud-on-the-market hypothesis was more closely related to transaction causation than loss causation. *Id.* The court explained:

> Our cases have not utilized the [fraud-on-the-market] theory to alter the loss causation requirement, and we refuse to do so here. Our decisions explicitly require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value.

Id. (*citing Huddleston*, 640 F.2d at 549). Because the plaintiffs were unable to show that the drop in stock price was related to the alleged misrepresentation, the court of appeals held that the plaintiffs had failed to satisfy the loss causation requirement. *Id.* at 1446, 1448-49.

Similar to the plaintiffs here, the plaintiffs in *Robbins* did not even attempt to link the alleged misrepresentations to any decline in the value of their investment. Instead, they simply claimed they paid too much. As the Eleventh Circuit concluded, where there is no connection between the alleged misrepresentation and a subsequent decline in stock price, a securities claim under Section 10(b) and Rule 10b-5 cannot survive because the essential element of loss causation cannot be established. *Id.* at 1448-49.

2. The Third Circuit

As the Ninth Circuit explicitly recognized, its decision is in conflict with the Third Circuit's application of loss causation at the pleading stage, which does "require a demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint." (Pet. App. 9a n.4). In *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000), plaintiffs, a class of investors, alleged that during a tender offer defendants made certain misrepresentations about Cendant that artificially inflated the price at which plaintiffs purchased shares of the company that Cendant was acquiring. In analyzing whether plaintiffs properly pleaded loss causation, the Third Circuit explained:

> Where the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation. In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.

Id. at 172. Accordingly, the court of appeals confirmed that in order to satisfy the loss causation requirement at the pleading stage, a plaintiff must establish that the alleged misrepresentations proximately caused the decline in the security's value. *Id.* Because the plaintiffs had not only alleged that they purchased shares at an inflated price, but also alleged that the price of their stock declined when the corrective disclosure was made known to the public, the court concluded that the complaint alleged sufficient facts to establish loss causation. *Id.*

3. The Second Circuit

The Ninth Circuit's decision is also in direct conflict with the recent decision of the Second Circuit in *Emergent Capital Investment Mgt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003), wherein the court clarified its prior holding in *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87 (2d Cir. 2001). Up until this time, the Second Circuit's decision in *Suez Equity* had been interpreted by some courts as suggesting that loss causation could be pleaded with an allegation merely that the stock price was inflated at the time of purchase due to an alleged misrepresentation or omission.[10]

As the Second Circuit explained in *Emergent*, its decision in *Suez Equity* does not mean that alleging a disparity in investment value at the time of purchase is, by itself, sufficient to satisfy the loss causation pleading requirement. 343 F.3d at 198. Such an allegation, noted the court of appeals, amounts to nothing more than a paraphrased allegation of transaction causation. *Id.* "While it may explain why plaintiff purchased [the] stock, it does not explain why it lost money on the purchase, the very question that the loss causation allegation must answer." *Id.*

The Second Circuit acknowledged that in *Suez Equity* it did refer to a disparity between transaction price and true investment quality at the time of purchase and had also observed that the plaintiffs suffered a loss at the time of purchase since the value of their stock was less than represented by the defendants. *Id.* The court of appeals

10. *Suez Equity* was one of only three cases that the Ninth Circuit relied on in support of its interpretation of loss causation. (Pet. App. 9a).

explained, however, it did not mean to suggest that a purchase-time loss allegation alone could satisfy the loss causation requirement. *Id.* The court concluded, "[w]e do not think *Suez Equity* undermined our established requirement that securities fraud plaintiffs demonstrate a causal connection between the content of the alleged misstatements or omissions and 'the harm actually suffered.'" *Id.* at 199.

Based on the Second Circuit's opinion in *Emergent Capital*, it is clear that the Ninth Circuit's reliance on *Suez Equity* was misplaced.

4. The Seventh Circuit

Similarly, in *Bastian v. Petron Resources Corp.*, 892 F.2d 680 (7th Cir. 1990), *cert. denied*, 496 U.S. 906 (1990), the Seventh Circuit required securities plaintiffs to adequately plead loss causation in order to survive a motion to dismiss. In *Bastian*, plaintiffs were investors in certain oil and gas limited partnerships who claimed that had it not been for the misleading omissions and misrepresentations made by the defendants in their offering memoranda, plaintiffs would not have invested in the then worthless partnerships. *Id.* In granting defendants' motion to dismiss under Rule 12(b)(6), the district court held that the complaint failed to allege loss causation. *Id.* at 682.

In affirming the dismissal, the Seventh Circuit examined the roots of the loss causation requirement in federal securities fraud cases and noted its fundamental importance. "[I]t is an instance of the common law's universal requirement that the tort plaintiff prove causation." *Id.* at 683-684. The Seventh Circuit made clear that because

the plaintiffs' investments declined due to a general decline in the oil industry, the plaintiffs had not lost anything as the result of the defendants' alleged fraud. *Id.* at 685. The court of appeals found that to award damages where plaintiffs would have lost their investment regardless of the fraud, would result in a windfall. *Id.* In further explaining the significance of establishing loss causation in securities fraud cases, the court explained: "[n]o social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation." *Id.*

B. Only The Eighth Circuit Agrees With The Ninth Circuit

The only Circuit with which the Ninth Circuit's interpretation of loss causation can logically be reconciled is the Eighth Circuit, which appears to accept the artificial price inflation theory in interpreting loss causation. In *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619-20 (8th Cir. 1991), the Eight Circuit held that in a fraud-on-the-market case, a plaintiff need only establish that a defendant's misrepresentations artificially inflated the price of the stock in order to satisfy the loss causation requirement. *See also Gebhardt v. Conagra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003) (loss causation may be presumed in a fraud-on-the-market case if there is a pleading of price inflation caused by misrepresentations).

C. This Court Should Resolve The Conflict

The Ninth Circuit here has held that in a fraud-on-the-market case, a plaintiff can establish loss causation by simply positing that the stock's value at the time of purchase was artificially inflated as a result of the misrepresentation. This decision cannot be reconciled with the interpretation of loss causation adopted and applied in a majority of the other Circuits, particularly the Second, Third, Fifth, Seventh, and Eleventh, all of which have either implicitly or explicitly rejected the theory espoused by the Eighth and Ninth Circuits, requiring instead that a plaintiff demonstrate a causal connection between the alleged misrepresentation and the investment's subsequent decline in value.

Since the passage of the Reform Act in 1995, approximately 1,894 federal securities fraud class actions have been filed. Stanford Securities Class Action Clearinghouse, *available at http://securities.stanford.edu* (last modified Dec. 15, 2003). In nearly all of these cases, loss causation is an issue. As long as the conflict among the Circuits persists, the varying interpretations of loss causation will continue to pose fundamental problems for every federal securities fraud case filed, at the pleading stage and beyond.

Commentators confirm that the conflict among the Circuits regarding the interpretation of loss causation is a significant one – one that will continue to affect securities fraud cases nationwide until a uniform and consistent interpretation is adopted. *See* Sarah S. Gold & Leon P. Gold, *Clarifying the Pleading of Loss Causation: A direct causal link between the alleged misrepresentation or omission and the economic loss suffered must be demonstrated*, 230 N.Y. L.J. 3, Oct. 8, 2003 at Col. 1 (noting that the conflict among the Circuits regarding

the interpretation of loss causation may ultimately need to be addressed by the Supreme Court); David M. Brodsky & Jeff G. Hammel, *The Fraud on the Market Theory and Securities Fraud Claims*, 230 N.Y. L.J. 4, Oct. 24, 2003, at Col. 4 (criticizing the Ninth Circuit's interpretation of loss causation as expanding the fraud-on-the-market theory to provide plaintiffs a rebuttable presumption of both transaction and loss causation); Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 Fordham L. Rev. 1781, 1782 (April 2000) (providing a detailed analysis of the split among Circuits in interpreting the loss causation requirement, as well as the legislative history of the Reform Act's codification of loss causation). As the division among the Circuits appears only to be getting wider, review by this Court is now appropriate.

II. The Ninth Circuit's Interpretation Of Loss Causation Cannot Be Squared With The Text Of The Reform Act

Through the Reform Act, Congress sought, in part, to establish uniform and stringent pleading requirements in securities fraud actions arising under Section 10(b) of the Securities Exchange Act of 1934. Specifically, Section 21D(b)(4) of the Reform Act, provides that "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4) (reproduced at Pet. App. 54a).

Uniform and meaningful application of the loss causation element is particularly important at the pleading stage because it is critical to fulfilling Congress' goal of imposing consistent

and more stringent pleading requirements. If plaintiffs cannot allege a causal nexus between the purported misrepresentation or omission and an investment's subsequent decline in value, the lawsuit should not proceed.

As required by the Reform Act, a plaintiff who brings a securities fraud claim has the burden of proving that the alleged fraud of the defendant caused the loss for which the plaintiff seeks to recover damages. The Ninth Circuit's interpretation of loss causation essentially renders the Reform Act's codification of loss causation meaningless. Under the Ninth Circuit's holding, shareholders do not need to prove – or even allege – that the corporate conduct on which their claim is based caused a drop in their stock price. Instead, all they need to do is claim the price at which they purchased the shares was artificially inflated because of the alleged fraud. This has serious implications. Loss causation ensures the existence of an identifiable nexus between a defendant's alleged misconduct and plaintiff's claimed losses. Consequently, it allows courts to take account of intervening factors, such as war or a recession, that may have caused the price to decline, in deciding whether and to what extent to hold a defendant in a securities fraud case liable.

In addition to codifying loss causation in the Reform Act, Congress also implemented therein an upward damages limitation in order to confine a plaintiff's recovery to those losses actually caused by the fraud and not by other market conditions which defendants did not cause. Specifically, Section 21D(e)(1) of the Reform Act provides:

> Except as provided in paragraph (2), in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference

> to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which *the information correcting the misstatement or omission that is the basis for the action is disseminated to the market*.

15 U.S.C. § 78u-4(e)(1) (emphasis added) (reproduced at Pet. App. 54a-55a). This provision of the Reform Act has been referred to as the "look back" provision. In defining a plaintiff's damages in a Section 10(b) securities case, this provision not only restricts the plaintiff's recovery to the amount of the post-transaction decline in value, but it also implicitly assumes that a corrective disclosure of the alleged misrepresentation or omission caused such a decline.[11]

The Ninth Circuit's interpretation of loss causation, which is based solely on a theory of price inflation at the time of purchase, is simply not practical in light of the Reform Act's "look back" provision. Under the Ninth Circuit's holding, a plaintiff can establish loss causation merely by alleging that the stock was artificially inflated as the result of defendant's fraud, but cannot recover damages if the stock price does not actually decline, or if it declines but rebounds within the 90-day "look back" period. Similarly, the plaintiffs here would not be entitled to any damages, even though in

11. In this regard, the interpretation of loss causation adopted in the Second, Third, Fifth, Seventh and Eleventh Circuits is consistent with the text of the Reform Act, in that they require plaintiffs to establish a causal connection between the alleged fraud and a subsequent decline in stock price.

the Ninth Circuit's view they adequately pleaded loss causation. Pursuant to the "look back" provision, damages are measured beginning on the day the corrective disclosure is made to the public. Here, the loss for which plaintiffs seek to recover is the stock price decline that occurred on February 24, 1998. However, the ostensible "corrective disclosure" relating to Albuterol Spiros was not made until November 3, 1998 – nine months after the close of the Class Period.[12] Congress could not possibly have intended such an absurd inconsistency between the loss causation requirement and the "look back" provision governing damages.

Although the "look back" provision does not explicitly require a plaintiff to prove that the defendant's fraud caused the post-transaction loss, requiring such a causal connection is implicit. Indeed, it is necessary in order for the damages provision to have any practical effect. If a defendant's fraud did not cause the post-transaction decline, it would make no sense to allow the plaintiff to use it as evidence for damages. Moreover, as noted by the Banking, Housing and Urban Affairs Committee of the United States Senate, by including the limitation on damages provision in the Reform Act, the Committee intended to rectify the uncertainty in calculating damages in securities fraud cases, "thereby limiting damages to those losses caused by the fraud and not other market conditions." S. Rep. No. 104-98 at 20 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 699.

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12. Interestingly, following the corrective disclosure relating to Albuterol Spiros, Dura's stock dropped from $12.375 on November 3, 2003 to $9.75 on November 4, 2003. SER, 79, Exh. L. However, twelve trading days later, its stock price closed at $12.438. *Id.* Ninety days later, at the end of the statutory "look back" period, Dura's stock price closed at $14.00, hitting a high during this period of $16.00. *Id.* Presumably, this escalation in share price prompted plaintiffs to end the Class Period on February 24, 1998, rather than November 3, 1998.

Collectively, the legislative history of the Reform Act, its codification of loss causation, and its "look back" provision provide a solid basis for developing a uniform approach to loss causation – one that requires a plaintiff to plead and prove a causal connection between the defendant's alleged misrepresentation or omission and the investment's subsequent decline in value. By removing the causal nexus that Congress intended to require, the Ninth Circuit's interpretation of loss causation frustrates the effective administration of the Reform Act and renders meaningless or superfluous several of its provisions. Because loss causation is an issue of nationwide application, immediate review by this Court is warranted.

CONCLUSION

For the foregoing reasons, the petition for a writ of *certiorari* should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT DATED AND FILED AUGUST 5, 2003

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 01-57136

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

v.

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; MITCHELL R. WOODBURY; MERILL LYNCH AND CO./MERRILL LYNCH, PIERCE FENNER AND SMITH, INC.; NISSAN MOTOR CO., a Japanese corporation,

Defendants-Appellees.

February 4, 2003, Argued and Submitted,
Pasadena, California
August 5, 2003, Filed

Appendix A

Before: Harry Pregerson, Stephen Reinhardt, and Glenn L. Archer, Jr.,* Circuit Judges.

ARCHER, Senior Circuit Judge:

Michael Broudo et al. ("Appellants") appeal the district court's dismissal with prejudice of the second amended complaint ("SAC") under Federal Rule of Civil Procedure ("FRCP") 12(b)(6). *In re Dura Pharm., Inc. Sec. Litig.*, No. 99CV0151-L(NLS) (S.D. Cal. Nov. 11, 2001). Because 1) the SAC satisfied the loss causation element of a Section 10(b) violation of the Securities and Exchange Act of 1934 with respect to the Albuterol Spiros device; and 2) the district court abused its discretion in not permitting Appellants to amend the SAC to include additional allegations regarding Dura's Ceclor CD sales, the district court's judgment is reversed and remanded.

BACKGROUND

This securities fraud case is a class action on behalf of investors who purchased Dura Pharmaceutical securities between April 15, 1997, and February 24, 1998 ("the class period"). This appeal is drawn specifically to alleged misleading and untrue statements made by Dura and its officials (collectively "Dura")[1] about Dura's Albuterol Spiros

* The Honorable Glenn L. Archer, Jr., Senior Circuit Judge, United States Court of Appeals for the Federal Circuit, sitting by designation.

1. Dura is a San Diego-based developer and marketer of prescription pharmaceutical products for the treatment of allergies, asthma, and related respiratory condition.

Appendix A

delivery device for asthma medication[2] and Dura's Ceclor CD antibiotic. During the class period, Dura issued several press releases[3] indicating satisfactory development and testing of the Albuterol Spiros Device and claiming rising sales of Ceclor CD, both of which Appellants allege were known to Dura and the individual defendants to be untrue. The most relevant statements are the following:

April 15, 1997 Press Release commenting on better-than-expected first quarter results: "Dura . . . announced that revenues and net income for the first quarter more than doubled over the same period last year." This press release also quoted a Dura official as stating that he was "very pleased with the first quarter results" and that "we are happy with the strong progress made in selling our new respiratory antibiotic Ceclor CD." The release further stated that "Patient dosing was completed for clinical trials needed for NDA (new drug application) submission of Spiros albuterol. . . ." (SAC ¶ 56)

June 5, 1997 Press Release: "Dura . . . announced the completion of the clinical trials necessary for a new drug application (NDA) submission for the Albuterol Spiros product. . . ." "We are pleased with the results to date and

2. The Albuterol Spiros system is a device used to dispense asthma medication which does not make it imperative that the patient inhale at the exact time the medicine is dispensed.

3. Other statements offered by Appellants are those made by analysts purporting to report what various Dura officials had told them. However, the complaint does not clearly attribute any of these comments to Dura officials, and they are not discussed further.

are preparing the NDA for filing in the latter half of this year." (SAC ¶ 79)

July 15, 1997 Press Release commenting on better-than-expected Q2 results: "We are pleased with Dura's performance in the second quarter of 1997. Ceclor CD . . . ha[s] been well received by physicians who are responding favorable to our promotional efforts. . . . We completed clinical trials necessary for NDA (new drug application) submission and are on track to file the Albuterol Spiros NDA on behalf of Spiros Corp. in the second half of 1997." (SAC ¶ 85)

October 14, 1997 Press Release, commenting on better-than-expected Q3 results: "Dura . . . today reported record earnings for both the third quarter and nine months year-to-date of 1997, compared to the same periods last year. . . . Pharmaceutical sales growth is principally attributable to the impact of new product acquisitions and introductions, such as Ceclor CD. . . ." (SAC ¶ 111)

November 10, 1997 Press Release, announcing submission of NDA: "Dura . . . today announced that it has submitted a new drug application (NDA) with the FDA for Albuterol Spiros." (SAC ¶ 123)

January 20, 1998 Press Release, commenting on better-than-expected Q4 results: "Dura reported record revenues . . . for the quarter and the full year. . . . 'During the past year we significantly strengthened both the pharmaceutical product marketing and the Spiros development arms of our business . . . We have continued to demonstrate our capabilities as a respiratory marketing force as shown by the

growth of our Ceclor CD market share . . . from 8% at the beginning of 1997 to 25% by year-end.' " (SAC ¶ 128)

In the class period, Dura's stock reached a high of $53 per share. On the last day of the class period, February 24, 1998, Dura revealed that it expected lowerthan-forecast 1998 revenues and 1998 earnings per share ("EPS") due to, *inter alia*, slower-than-expected sales of Ceclor CD. Dura's stock then dropped from $39 1/8 on February 24, 1998, to $20 3/4 on February 25, 1998, a 47% one-day loss. Throughout the remainder of 1998, Dura's business declined. In an April 16, 1998 conference call with stock analysts, Dura revealed that as early as December 1997, wholesale channels had been clogged with many months of excess inventory and that actual sales of several products, including Ceclor CD, had in fact been declining. Later, in November 1998, Dura also revealed that the FDA found the Albuterol Spiros device not approvable due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns.

Appellants filed several class actions alleging violations of sections 10(b) and 20(a) of the Securities and Exchange Act and Rule 10b-5 promulgated by the Securities Commission, which, in due course, were consolidated. The district court granted Dura's motion to dismiss the Consolidated and Amended Complaint but dismissed it without prejudice. In doing so, the court instructed the Appellants as follows:

> The amended complaint shall comply with Federal Rule of Civil Procedure 8, and concisely set forth each allegedly false or misleading statement or

> omission, and follow each statement or omission with the specific reasons why the statements were false when made or why the Defendants had a duty to disclose. In addition, the Plaintiffs shall specify which Defendants made the statements and knew the "true facts" that should have been disclosed.

In re Dura Pharmaceuticals, Inc. Securities Litigation, 2000 U.S. Dist. LEXIS 15258, No. 99cv0151-L(NLS) Slip op. at 26 (S.D. Cal. Jul. 12, 2000). Appellants subsequently filed the SAC which the district court also dismissed, this time, however, with prejudice.

With respect to the Albuterol Spiros device, the district court found that Appellants had not properly pled the loss causation element of a 10(b) violation. Specifically, the district court focused on the last day of the class period—February 28, 1998—and Dura's revelation that day which led to the large drop in stock price:

> The SAC does not contain any allegations that the FDA's non-approval [of the Albuterol Spiros device] had any relationship to the February price drop. Accordingly, the SAC does not explain how the alleged misrepresentations and omissions regarding Albuterol Spiros "touched" upon the reasons for the decline in Dura's stock price. Rather, the decline in Dura's stock price was the result of an expected revenue shortfall. Accordingly, the SAC's allegations regarding Albuterol Spiros are insufficient to state a claim.

In re Dura Pharm., 2000 U.S. Dist. LEXIS 15258, slip op. at 15. The district court reasoned further that because the February 24 announcement did not mention the Albuterol Spiros device, any omissions or misleading statements about this device could not be said to have caused the decline in price. Therefore, the district court ruled that the loss causation element was not met.

Turning to Dura's statements regarding Ceclor CD sales made during the class period, the district court found that Appellants' allegations in the SAC were not sufficient to indicate that these statements were false and made with knowledge of their falsity. *Id.* 2000 U.S. Dist. LEXIS 15258, at 20. The district court therefore held that the allegations in the SAC were not sufficient to withstand a motion to dismiss based on the scienter requirement for a § 10(b) violation. *Id.*

The district court then dismissed the complaint with prejudice "[b]ecause the Plaintiffs have had an opportunity to amend the complaint to meet the pleading requirements under the PSLRA and *Silicon Graphics*." *Id.* 2000 U.S. Dist. LEXIS 15258, at 23. This appeal followed, and we have jurisdiction under 28 U.S.C. § 1291.

DISCUSSION

A complaint's dismissal under FRCP 12(b)(6) is reviewed *de novo*. *See Howard v. Everex Sys.*, 228 F.3d 1057, 1060 (9th Cir. 2000). And on review, the court must accept the complaint's well-pleaded allegations as true and construe them in the light most favorable to the plaintiff. *See In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 983 (9th Cir. 1999). A district court's denial of leave to amend is reviewed

for abuse of discretion. *See In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1097 (9th Cir. 2002).

In order for plaintiffs to properly allege a claim brought under § 10(b) of the Securities Exchange Act of 1934, they must state the following: (1) defendants made a false statement or omission with regard to a material fact; (2) in connection with the purchase or the sale of a security; (3) with scienter; (4) upon which plaintiffs reasonably relied; and (5) that proximately caused the alleged loss. *See Binder v. Gillespie*, 184 F.3d 1059, 1063 (9th Cir. 1999).

Loss Causation

"The causation requirement in Rule 10b-5 securities fraud cases includes 'both transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused the harm.' " *Id.* at 1065 (*quoting McGonigle v. Combs*, 968 F.2d 810, 820 (9th Cir. 1992)). In this circuit, loss causation is satisfied where "the plaintiff shows that 'the misrepresentation touches upon the reasons for the investment's decline in value.' " *Id.* at 1066 (*quoting McGonigle*, 968 F.2d at 821); *accord Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir. 1996); *Binder*, 184 F.3d 1059 at 1066 (9th Cir. 1999).

This "touches upon" language is admittedly ambiguous. *See Binder*, 184 F.3d at 1066 (stating that the "loss causation requirement in this circuit and others has been less than clear"); *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (stating "[a]lthough there may be other acceptable formulations of this [loss causation] element, the

[trial] court's instruction was proper"). Our cases have held, however, that: "[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." *Knapp*, 90 F.3d at 1438 (emphasis added) (*citing Gray v. First Winthrop Corp.*, 82 F.3d 877, 886 (9th Cir. 1996)); *see also Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 2003 U.S. App. LEXIS 13257, at *18 (8th Cir. June 30, 2003) ("[P]laintiffs were harmed when they paid more for the stock than it was worth. This is a sufficient allegation."); *Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 97-98 (2d Cir. 2001) ("[P]laintiffs may allege transaction and loss causation by averring both that they would not have entered the transaction but for the misrepresentations and that the defendants' misrepresentations induced a disparity between the transaction price and the true 'investment quality' of the securities *at the time of transaction.*") (emphasis added). Accordingly, for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the transaction. *See Gray*, 82 F.3d at 886; *Knapp*, 90 F.3d at 1438. It is at that time that damages are to be measured. Thus, loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause.[4]

4. By contrast, other circuits are less favorable to plaintiffs and do require demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint. *See, e.g., Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000) ("Where the value of

(Cont'd)

Here the district court found that Appellants' allegations in the SAC regarding the Albuterol Spiros device were insufficient to state a claim of securities fraud because they did not explain how the loss causation element was satisfied. Specifically, the court found "[t]he SAC does not contain any allegations that the FDA's non-approval [of the Albuterol Spiros device] had any relationship to the February price drop. Accordingly, the SAC does not explain how the alleged misrepresentations and omissions regarding Albuterol Spiros 'touched' upon the reasons for the decline in Dura's stock price." *Dura Pharm.*, 2000 U.S. Dist. LEXIS 15258, slip op. at 15. This reasoning presumes that the loss causation element requires a demonstration of a corrective disclosure followed by a stock price drop during the class period and that those facts must be alleged in the complaint. As we explain, it is necessary in the pleading to allege 1) that the stock's price at the time of purchase was overstated and 2) sufficient identification of the cause for this overvaluation. Appellants have pled that the price of the stock was overvalued in part due to the misrepresentations by Dura and the individual defendants that the development and testing of the Albuterol

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(Cont'd)

the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation. In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price."); *Robbins v. Kroger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997) ("Our decisions explicitly require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value.")

Spiros device were proceeding satisfactorily and that FDA approval of the device was imminent. Accordingly, the district court erred by finding that appellants failed to plead loss causation sufficient to survive a motion to dismiss with regard to statements concerning the Albuterol Spiros device.

Scienter

The pleading requirements for securities fraud actions are articulated in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). First, the complaint must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. §§ 78u-4(b)(1) (2000). The second requirement of the PSLRA is that the plaintiff plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §§ 78u-4(b)(2) (2000).

This court recently summarized the scienter requirement: "The complaint must allege that the defendant made false or misleading statements either intentionally or with deliberate recklessness or, if the challenged representation is a forward looking statement, with 'actual knowledge . . . that the statement was false or misleading.' " *In re Vantive Sec. Litig.*, 283 F.3d 1079, 1085 (9th Cir. 2002). Accordingly, "[w]here pleadings are not sufficiently particularized or where, taken as a whole, they do not raise a 'strong inference' that misleading statements were knowingly or deliberate recklessness [sic] made to investors, a private securities fraud

complaint is properly dismissed under Rule 12(b)(6)." *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001). We must decide whether the Appellants met this scienter requirement with regard to their allegations concerning Dura's Ceclor CD sales.

At issue are statements made by Dura reporting increased market share of Ceclor CD and expressing optimism with respect to Ceclor CD's future results. Specifically, the SAC alleges that Dura made misrepresentations that sales of Ceclor CD had been positive throughout the year when it issued statements indicating that Dura was "pleased" with the sales results of various quarters and that the company was "happy" with the strong progress made in selling Ceclor CD throughout the year. (SAC ¶¶ 56, 85, 111, 128). Appellants allege that these statements were false or misleading because sales of Dura's major drug products were flat or declining, particularly Ceclor CD, with actual sales to consumers dropping throughout the class period. (SAC ¶ 58(a)). Appellants further allege that the defendants knew of these declining sales through specialized reports which compared actual versus planned sales of Dura's drug products. (SAC ¶ 62) Thus, the defendants were kept apprised of Dura's drug sales and knew that such sales were below plan and insufficient for Dura to achieve continued growth in sales and earnings. (SAC ¶ 62).

To support the allegations that Dura was aware of the falsity of the favorable statements, Appellants further allege Dura and the individual defendants engaged in insider trading, raised capital through a stock offering, and engaged in "channel stuffing" (the premature pushing of product into the wholesale channels to artificially inflate sales):

> [i]n order to cover up the sales shortfalls . . . Dura was engaging in a subterfuge to artificially inflate its revenues and EPS by shipping excessive amounts of Ceclor CD and other products to wholesalers, who were enticed to take the product by price discounts, extended payment terms and/or other incentives. As a result, Dura's Ceclor CD and other product inventories in the distribution channel were greatly in excess of the normal one-month supply. As a result of this practice, Dura's Ceclor CD sales were artificially inflated and Dura's insiders knew that as a result of "borrowing" millions of dollars of sales of Ceclor CD from future periods, Dura's sales of Ceclor CD would fall sharply once this practice stopped.

(SAC ¶ 58(d)).

The district court discussed each of these allegations separately and concluded that each was insufficient to show scienter. As explained above, the pleading requirement for the element of scienter in a securities fraud case is high. The existence of reports that showed Ceclor CD sales were below internal projection and Dura's knowledge of these reports, coupled with Dura's statements that it was pleased with sales figures, are not specific facts that strongly suggest actual intent by Dura to mislead investors. In fact, Dura's internal expectations could have been aggressive and falling short of them may have been anticipated. Further, while unusual stock or suspicious stock sales can serve as circumstantial inference of scienter, *see In re Silicon Graphics*, 183 F.3d at 986, the allegations of insider trading

in the SAC do not indicate that the individual defendants' trading practices were dramatically out of line with their prior trading activities. Turning to the "channel stuffing" allegations, as the district court explained, channel stuffing claims may have some probative value insofar as the channel stuffing was done so as to artificially inflate income, but there may also be other legitimate reasons for attempting to achieve sales earlier. We see no fault with the district court's conclusion that here the allegation of channel stuffing was insufficient for scienter.

While the district court did a detailed analysis of the Appellants' separate arguments for scienter, its task was not complete. This court has made clear that allegations of scienter must be collectively considered: "Beyond each individual allegation we also consider 'whether the total of plaintiffs' allegations, even though individually lacking, are sufficient to create a strong inference that defendants acted with deliberate or conscious recklessness.' " *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 938 (9th Cir. 2003) (quoting *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1038 (9th Cir. 2002)) (emphasis added). Accordingly, we must vacate the district court's finding of no scienter. On remand the district court should perform the final step of considering the Appellants' allegations collectively when conducting its scienter analysis.[5]

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5. We express no opinion as to whether the allegations in the SAC in totum rise to the level necessary for scienter. Indeed, this would be premature because of our decision that Appellants should be permitted to amend the complaint (see below), which may result in additional scienter allegations.

Leave to Amend

Finally, Appellants assert they should have been granted the opportunity to amend the SAC. Leave to amend under FRCP 15 is to be liberally applied. Where the plaintiff offers to provide "additional evidence" that would add "necessary details" to an amended complaint and such offer is made in good faith, leave to amend should be granted. *See Eminence Capital v. Aspeon, Inc.*, 316 F.3d 1048, 1053 (9th Cir. 2003) (holding that the district court erred in not granting leave to amend the complaint in a securities fraud case in order for plaintiffs to meet the scienter requirement of the PSLRA). Specifically, "[d]ismissal with prejudice and without leave to amend is not appropriate unless it is clear on *de novo* review that the complaint could not be saved by amendment." *Id.* at 1052.

With respect to Ceclor CD sales, Appellants seek to amend the SAC to include, *inter alia*, statements by a confidential witness who has direct knowledge that at least two of the defendants discussed how they could make stock analysts "perceive" that Dura was doing better than it actually was and that one of the defendant's oft-stated catch phrase to employees who questioned his tactics was "let 'em catch us." Such allegations are the type that could demonstrate a strong inference that Dura knowingly or with deliberate recklessness made false or misleading statements to investors. Accordingly, we cannot say that the SAC could not be saved by amendment.

Appendix A

Because it appears that Appellants had a reasonable chance of successfully stating a claim if given another opportunity, the district court abused its discretion in denying leave to amend the SAC.[6]

CONCLUSION

Dura invites us to affirm the district court's judgment based on issues not decided by the district court. Specifically, Dura asserts that the alleged misleading statements are not actionable because they are protected by the safe harbor and bespeaks caution doctrines, that non-speaking defendants cannot be liable under section 10(b), and that Appellants failed to plead "all facts" to support their "information and belief" allegations. While Dura is correct that we may affirm the district court's judgment on a different ground, we need not do so. Indeed, we usually do not. *See Andersen v. Cumming*, 827 F.2d 1303, 1305 (9th Cir. 1987) (stating "[o]rdinarily we will not decide an issue that was not addressed by the district court") (citing *Greater Los Angeles Council of Deafness v. Zolin*, 812 F.2d 1103, 1107 (9th Cir. 1987)). We decline Dura's invitation for this reason. Further, because we are granting Appellants leave to amend the SAC, Dura's "other" arguments may be mooted by such amendment. Accordingly, it would be improper for us to rule on those issues.

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6. Additionally, Appellants seek to amend the SAC by alleging the contents of specific conversations between confidential witnesses and Dura insiders which would further corroborate the allegations concerning the Albuterol Spiros device. We see no reason to limit amendments to the SAC to allegations concerning Ceclor CD sales.

Appendix A

We hold Appellants have sufficiently pled loss causation to survive a motion to dismiss with regard to statements concerning the Albuterol Spiros device. Additionally, Appellants have shown that they should have been granted leave to amend the SAC. Therefore, the judgment of the district court is

REVERSED AND REMANDED.

APPENDIX B — ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA DATED NOVEMBER 2, 2001

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

Civil No. 99cv0151-L(NLS)

IN RE DURA PHARMACEUTICALS, INC.
SECURITIES LITIGATION,

This Document Relates to: All Actions

ORDER GRANTING DEFENDANTS' MOTION TO DISMISS AND DISMISSING SECOND CONSOLIDATED AND AMENDED COMPLAINT WITH PREJUDICE

[Docket No. 75]

This matter came on regularly for a hearing on Defendants' motion to dismiss the Second Consolidated Amended Complaint ("SAC"). Henry Rosen and Tor Gronborg of Milberg Weiss Bershad Hynes & Lerach LLP, and Alan Schulman of Bernstein Litowitz Berger & Grossman, LLP appeared for the Plaintiffs. William F. Sullivan, Christopher H. McGrath, and Sean T. Prosser of Brobeck, Phleger & Harrison, LLP appeared for the Defendants.

FACTUAL BACKGROUND

Plaintiffs bring this action on behalf of purchasers of shares of Dura Pharmaceuticals, Inc. ("Dura" or the "Company")

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securities from April 15, 1997 to February 24, 1998 ("Class Period"). (Second Consolidated Amended Complaint ("SAC") ¶ 1.) Dura is a San Diego-based developer and marketer of prescription pharmaceutical products for the treatment of allergies, asthma, and related respiratory conditions. (SAC ¶ 48.) The Individual Defendants held the following positions at Dura during the Class Period: Cam L. Garner ("Garner") was President, Chief Executive Officer and Chief Operations Officer and Chairman; James W. Newman ("Newman") was Senior Vice President-Finance & Administration and Chief Financial Officer; Charles W. Prettyman ("Prettyman") was Senior Vice President-Development and Regulatory Affairs; Walter F. Spath ("Spath") was Senior Vice President-Sales & Marketing; Mitchell R. Woodbury ("Woodbury") was Senior Vice President/General Counsel; Julia R. Brown ("Brown") was Senior Vice President-Business Development and Planning; and Joseph C. Cook ("Cook") was a director (these defendants are referred to collectively as "Individual Defendants"). (SAC ¶ 49.)

Dura became a publicly-traded company in 1992, pursuing a business strategy of marketing niche pharmaceutical drugs. (SAC ¶ 1.) At that time, Dura typically purchased the rights to market drugs developed by large pharmaceutical companies that were approaching the end of their profitability to those companies. *Id.* By 1995, Dura's management realized that given the Company's size, it would be increasingly difficult to achieve continued revenue and earnings per share ("EPS") growth solely by acquiring marketing rights to niche drugs. *Id.* Therefore, Dura insiders decided to diversity its business, and become a medical device development company and develop its own proprietary drug products. *Id.* In 1995, Dura

began developing the Spiros drug delivery system for Albuterol ("Albuterol Spiros" or "Spiros drug delivery system"), a method of aerosolizing powders so that asthma medicines, including Albuterol, could be inhaled. (SAC ¶ 2.) This system purportedly would have advantages over existing inhalers that depended on the user to successfully coordinate the use of the inhaler and inhalation of the medication. *Id.*

Dura's insiders created Spiros Development Corporation ("Spiros I") to incur Dura's costs of developing the Spiros drug delivery system. (SAC ¶ 4.) In addition, while phase III clinical trials of Albuterol Spiros were being completed, Defendants were taking steps to complete a major debt offering. (SAC ¶ 18.) According to Plaintiffs, the creation of Spiros I, the debt offering, and the Individual Defendants' concern over the value of their stock options and cash bonuses pushed Defendants to drive up the price of Dura's stock and keep it at high levels. (SAC ¶¶ 5, 19-20.) To this end, Plaintiffs contend that beginning in April 1997 and continuing through the Class Period, Defendants began a "concerted campaign to falsely persuade investors that Dura's sales were increasing and that Dura was successfully completing the development and clinical trials of the Spiros drug delivery system." (SAC ¶ 21.) Plaintiffs maintain Defendants engaged in improper revenue recognition, misrepresented the effectiveness of its sales force, and misrepresented and omitted material information about the development of Albuterol Spiros. (SAC ¶¶ 21-31.) Plaintiffs also contend that during the Class Period, the Individual Defendants engaged in suspicious insider trading, selling 188,626 shares for over $7.3 million between May 12, 1997 and July 22, 1997. (SAC ¶¶ 24, 37, 154-70.)

During the Class Period, Dura's stock reached a high of $53 per share. (SAC ¶ 37.) On the last day of the Class Period, February 24, 1998, Dura revealed that it expected lower than forecast 1998 revenues and 1998 EPS due to slower-than-expected sales of the Ceclor CD and Nasarel/Nasalide product lines, and to the decision to increase the size of its sales force from 270 to over 450 to try to boost sales of existing products. (SAC ¶¶ 32, 134.) Dura's stock thereafter dropped from $39 1/8 on February 24, 1998, to $20 3/4, on February 25, 1998, an 18 3/8 point, 47% one-day decline on a volume of 32 million shares. (SAC ¶¶ 32, 134.) During the balance of 1998, Dura's business declined. (SAC ¶¶ 34, 135.) In an April 16, 1998, conference call Dura revealed that at least by December 1997, the wholesale channels had been clogged with many months of excess inventory, and that sales of several products were declining. (SAC ¶¶ 34, 135.) Dura also stated that its sales force was inadequate and had been plagued by very high turnover, and as a result, contributing to the poor sales of its drug products. (SAC ¶¶ 34, 135.) In November 1998, Dura revealed that the FDA had found that Albuterol Spiros was not approvable due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns. (SAC ¶¶ 33, 136.) Ultimately, Dura abandoned its efforts to obtain FDA approval of Albuterol Spiros. (SAC ¶¶ 35, 136.) Also after the Class Period, Dura attempted to form an affiliate company (DJ Pharma) to co-promote the Rondec product line it had acquired from Abbott Laboratories on June 30, 1995 for $35 million. (SAC ¶ 145). But by December 1998 the transaction was not finalized and Dura had to reconsolidate DJ Pharma back into Dura. (SAC ¶ 145.) At some point thereafter, Dura took a $28 million charge for the impairment of Rondec. *Id.*

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Plaintiffs filed several class actions alleging violations of sections 10(b) and 20(a) of the Securities and Exchange Act and Rule 10b-5 promulgated by the Securities and Exchange Commission. The cases were consolidated into the instant case number. By order dated July 12, 2000, this Court granted the Defendants' motion to dismiss the Consolidated and Amended Complaint, and dismissed the pleading without prejudice. Plaintiffs subsequently filed the SAC that is the subject of the instant motion.

DISCUSSION

I. Applicable Law Regarding Motions to Dismiss Securities Fraud Complaints.

A motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) tests the sufficiency of the complaint. *Navarro v. Block*, 250 F.3d 729, 732 (9th Cir. 2001). Dismissal of a claim under this Rule is appropriate only where "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *Navarro*, 250 F.3d at 732. Dismissal is warranted under Rule 12(b)(6) where the complaint lacks a cognizable legal theory. *Robertson v. Dean Witter Reynolds, Inc.*, 749 F.2d 530, 533-34 (9th Cir. 1984); *see Neitzke v. Williams*, 490 U.S. 319, 326-27 (1989) ("Rule 12(b)(6) authorizes a court to dismiss a claim on the basis of a dispositive issue of law."). Alternatively, a complaint may be dismissed where it presents a cognizable legal theory yet fails to plead essential facts under that theory. *Robertson*, 749 F.2d at 534.

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In reviewing a motion to dismiss under Rule 12(b)(6), the court must assume the truth of all factual allegations and must construe them in the light most favorable to the nonmoving party. *Cahill v. Liberty Mut. Ins. Co.*, 80 F.3d 336, 337-38 (9th Cir. 1996). However, legal conclusions need not be taken as true merely because they are cast in the form of factual allegations. *Roberts v. Corrothers*, 812 F.2d 1173, 1177 (9th Cir. 1987); *Western Mining Council v. Walt*, 643 F.2d 618, 624 (9th Cir. 1981). When ruling on a motion to dismiss, the court may consider the facts alleged in the complaint, documents attached to the complaint, documents relied upon but not attached to the complaint when authenticity is not contested, and matters of which the Court takes judicial notice. *Parrino v. FHP, Inc.*, 146 F.3d 699, 705-06 (9th Cir. 1998); *Branch v. Tunnell*, 14 F.3d 449, 453-54 (9th Cir. 1994); *MGIC Indem. Co. v. Weisman.*, 803 F.2d 500, 504 (9th Cir. 1986).

Section 10(b) of the Securities and Exchange Act of 1934 makes it unlawful to use in connection with "the mails or facilities of interstate commerce" any "manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commissioner may prescribe." 15 U.S.C. § 78j. SEC Rule 10b-5, promulgated under section 10(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

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(a) To employ any device, scheme or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

In order for Plaintiffs to properly allege their first claim of relief brought under section 10(b) of the Exchange Act and SEC Rule 10b-5, they must state the following: (1) defendants made a false statement or omission with regard to a material fact; (2) in connection with the purchase or the sale of a security; (3) with scienter; (4) upon which plaintiff reasonably relied; (5) to his/her harm or detriment. *Binder v. Gillespie*, 184 F.3d 1059, 1063 (9th Cir. 1999), *cert. denied*, 528 U.S. 1154 (2000); *Paracor Fin., Inc. v. General Elec. Capital Corp.*, 96 F.3d 1151, 1157 (9th Cir. 1996). Scienter is a "mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12 (1976); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 975 (9th Cir. 1999).

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In December of 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA") to establish uniform and stringent pleading requirements for securities fraud actions. The PSLRA specifies the required pleading standard for securities fraud actions:

(1) Misleading statements and omissions

In any private action arising under this chapter in which the plaintiff alleges that the defendant —

(A) made an untrue statement of a material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which the were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. §78u-4(b)(1).

In addition, the PSLRA requires complaints alleging federal securities fraud to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). As recently interpreted by the Ninth Circuit, this language requires a private securities plaintiff to plead, particular facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct. In *re Silicon Graphics*, 183 F.3d at 977. Recklessness satisfies the scienter requirement only insofar as it reflects some degree of conscious or deliberate misconduct; *i.e.*, "a degree of recklessness that strongly suggests actual intent." *Id.* at 979.

The PSLRA further provides that "the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met." 15 U.S.C. § 78u-4(b)(3)(A).

Under Ninth Circuit caselaw, Rule 9(b) imposes two distinct requirements on complaints alleging securities fraud. First, the basic notice requirements of Rule 9(b) require the complaint to "state precisely the time, place, and nature of the misleading statements, misrepresentations, or specific acts of fraud." *Kaplan v. Rose*, 49 F.3d 1363, 1370 (9th Cir. 1994). The Rule imposes a second requirement that the complaint "set forth an explanation as to why the statement or omission complained of was false and misleading." *Yourish v. California Amplifier*, 191 F.3d 983, 993 (9th Cir. 1999) (*quoting In re GlenFed Sec. Litig.*, 42 F.2d 1541, 1548 (9th Cir. 1994) (en banc)). A complaint may satisfy this second requirement in many ways. It may demonstrate that the false or misleading character of a statement was clear

from facts that existed all along and were later revealed. *Yourish*, 191 F.3d at 994; *In re GlenFed*, 191 F.3d at 1549; *DeMarco v. DepoTech Corp.*, 149 F. Supp. 2d 1212, 1223 (S.D. Cal. 2001). It may also "poin[t] to inconsistent contemporaneous statements or information . . . which were made by or available to the defendants." *Yourish*, 191 F.3d at 994 (*quoting In re GlenFed*, 42 F.3d at 1549); *DeMarco*, 149 F. Supp. 2d at 1223. A complaint may not, however, demonstrate that a statement was false or misleading when made "merely by pointing to later inconsistent statements or conditions." *In re GlenFed*, 42 F.3d at 1548; *DeMarco*, 149 F. Supp. 2d at 1223.

II. Sufficiency of the SAC's Allegations.

Plaintiffs contend that Defendants misrepresented the Company's sales and business performance throughout the Class Period and thereby inflated Dura's stock price. Specifically, Plaintiffs contend Defendants misrepresented: (1) the effectiveness of its sales force; (2) the development of its Spiros Albuterol product; (3) the sales and success of Rondec; (4) and the sales of its major drugs, including Ceclor and Nasalide. The Court will address the sufficiency of these allegations in turn.

A. Statements Regarding Dura's Sales Force.

Plaintiffs contend that Defendants made numerous representations regarding the quality of its sale force. Specifically, on April 15, 1997, in its 1996 Annual Report, Dura stated that it was

able to access about 52% of total respiratory prescriptions written with its highly focused, yet relatively small, sales and marketing organization. The Company's goal is to increase its sales organization to approximately 280 by year-end 1997.

* * *

Dura's highly motivated sales people have proven sales records. . . . Their concentration on respiratory disease, coupled with extensive product and sales training, differentiates them from their competition.

* * *

> Dura's highly trained sales representatives have established credibility. . . . Due to the concentrated nature of the Company's target market, Dura can achieve significant penetration with a relatively small sales force.

(SAC ¶ 51.) Plaintiffs allege that less than one month later, on May 7 and 9, 1997, analysts UBS Securities ("UBS") and William Blair & Co. ("William Blair"), respectively, issued reports on Dura after discussions with Garner and Newman and repeated information provided by them. (SAC ¶ 75.) In these reports, the analysts stated that Dura expected to have 350 reps in place by the time Albuterol Spiros is introduced in late 1998. (SAC ¶ 75.) Similarly, Plaintiffs contend that on June 30, 1997, William Blair reported that

Newman told analysts, money portfolio managers, institutional investors, brokers and stock traders in a formal presentation that:

> One of the main reasons Dura could capture additional licensing/co-promotion agreements was that it had a highly specialized sales force of about 250 reps that were focused on the respiratory prescription market. Although Dura's sales force was relatively small, it still could call on almost 45-50% of the high respiratory prescription writers.

(SAC ¶ 82.)

Plaintiffs also state Dura misrepresented the quality and effectiveness of its sales force in a July 15, 1997 press release, when Dura reported better-than-expected Q2 1997 results. (SAC ¶ 85.) In the press release, Garner stated that part of the quarter's success was due in part to Dura "benefitting from [its] more experienced and expanded sales force, which currently totals approximately 225 representatives. . . ." (SAC ¶ 85.) Similarly, when reporting better-than-expected Q3 1997 results, Dura issued a press release where Garner stated that the increase in Dura's revenues was due in part to "the expansion of the sales force." (SAC ¶ 111.) Vector Securities International ("Vector") reported that in a follow-up conference call on October 14, 1997, Defendants stated that the Company projected it would have 300 sales reps by the end of the year and 350 reps at the point that Albuterol Spiros would be launched. (SAC ¶ 112.) Finally, Plaintiffs allege that when Dura issued a press-release regarding its better-than-expected Q4 1997 results, it represented that revenues had increased

in part because of "the increased productivity of the Company's expanded sales force." (SAC ¶ 128.)

Plaintiffs allege these statements were false when made because in reality, Dura's sales force was inefficient, underpaid, and suffered from an extremely high rate of turnover. (SAC ¶¶ 52, 77.) In part, this was due to the fact that compensation packages for Dura sales representatives were not competitive with the rest of the pharmaceutical industry. (SAC ¶¶ 52, 77.) Plaintiffs contend that "Dura frequently ignored its stated requirement that sales applicants have a minimum of two years of prior sales experience, thereby reducing the collective quality of the sales force." (SAC ¶¶ 52, 77.) Additionally, Plaintiffs maintain the sales force was hampered by a non-operational software and sales force hand-held computer system during the Class Period. (SAC ¶¶ 53, 58(c), 77.) In particular, malfunctions with the "Precise System" that the contractor installed seven months late in April 1997 hampered Dura's sales force's performance. (SAC ¶¶ 53, 77.) By December 1997, these malfunctions allegedly worsened to the point they prevented Dura from preparing necessary quarterly inventory reports or accurate FDA reporting. (SAC ¶¶ 53, 77.) Plaintiffs allege that in fact, Dura was encountering "serious and persistent problems with its sales force which was inadequately trained, was suffering from very high turnover and was insufficient in number and skill to adequately market Dura's drug products, including Ceclor CD, Keftab and Rondec." (SAC ¶ 58(b), 8b(b), 114(b), 129.)

Plaintiffs' allegations regarding the falsity of the Company's statements are conclusory and insufficient. There are no factual allegations to support the assertion the sales

force was suffering from serious and persistent problems, and were inefficient and underpaid, or that Defendants knew this at the time. Rather, the SAC states that sometime after the Class Period Dura admitted that its sales force was inadequate and suffered from a high rate of turnover, which contributed to Dura's poor sales. (SAC ¶¶ 34, 135.) These post-Class Period statements fail to establish that the Defendants' statements during the Class Period were false and made with knowledge of their falsity. *See In re GlenFed*, 42 F.2d at 1548 (stating that a complaint cannot demonstrate that a statement was false or misleading when made "merely by pointing to later inconsistent statements or conditions"); *DeMarco*, 149 F. Supp. 2d at 1223 (same). The SAC also does not contain the requisite detail to support its position that the sales force did not have the requisite two years' experience. The most specificity alleged is regarding Dura's dissatisfaction with the "Precise System" from Walsh International. (*See* SAC ¶¶ 53-54 and Exh. A thereto.) But the malfunctions with the Precise System do not necessarily support the conclusion that the sales force lacked the requisite skill to market Dura's products.

The SAC also is conclusory in alleging scienter regarding these problems with the sales force. Plaintiffs contend Defendant Woodbury sent a letter to Walsh complaining about the Precise System and therefore Defendants knew about the problems plaguing Dura's inventory systems. (SAC ¶¶ 54, 78 and Exh. A thereto.) That letter, however, does not contain any admissions that Dura's sales force was substandard. (SAC Exh. A.) Rather, the letter details the deficiencies of the Precise System and rescinds the agreement between Walsh and Dura. *Id.*

Plaintiffs also allege that Defendants knew about the sub-standard quality of the sales force because Defendants were "hands-on" managers and attended weekly executive management meetings from 8:00 to 10:00 a.m. every Monday. (SAC ¶¶ 59, 87, 115, 129, 148-49.) A complaint does not adequately plead scienter by claiming that key officers knew the true facts by virtue of their "hands-on" positions, involvement in the day-to-day management of the company, and access to various internal documents and reports. *See In re Splash Sec. Litig.*, 160 F. Supp. 2d 1059, 1079-81 (N.D. Cal. 2001) (holding that allegations of scienter based on unspecified corporate documents, unspecified conversations with corporate officers and employees, attendance at unspecified meetings, and unspecified communications with customers were insufficient); *In re Autodesk, Inc. Sec. Litig.*, 132 F. Supp. 2d 833, 843-44 (N.D. Cal. 2000) (holding that "plaintiffs must do more than allege that these key officers had the requisite knowledge by virtue of their 'hands on' positions, because that would eliminate the necessity for specially pleading scienter, as any corporate officer could be said to possess the requisite knowledge by virtue of his or her position"); *In re Read-Rite Corp. Sec. Litig.*, 115 F. Supp. 2d 1181, 1185 (N.D. Cal. 2000) (stating that "[o]ne *reasonably* could infer that persons with [defendants'] job titles would be aware of major developments concerning a key customer's refusal to implement a major product line. However, under current law, the mere existence of a reasonable inference does not satisfy the Reform Act's requirement of a strong implication."). Accordingly, these allegations are do not sufficiently plead scienter.

Further, insofar as Plaintiffs rely on indirect evidence of scienter based on insider stock sales, those allegations are

deficient. Unusual or suspicious stock sales can serve as circumstantial inference of scienter. *In re Silicon Graphics*, 183 F.3d at 986; *In re Splash*, 160 F. Supp. 2d at 1081; *In re Petsmart, Inc. Sec. Litig.*, 61 F. Supp. 2d 982, 999-1000 (D. Az. 1999). "But, courts have repeatedly held that the mere existence of stock sales does not raise a strong inference of fraudulent intent. [citation] Plaintiffs have the burden at the pleading stage of explaining why the stock sales were unusual or suspicious." *In re Petsmart*, 61 F. Supp. 2d at 1000; *See In re Silicon Graphics*, 183 F.3d at 986. To meet this burden, the plaintiffs must show the trading was "'in amounts dramatically out of line with prior trading practices, at times calculated to maximize personal benefit from undisclosed inside information.'" *In re Petsmart*, 61 F. Supp. 2d at 1000 (*quoting Alfus v. Pyramid Tech. Corp.*, 764 F. Supp. 598, 605 & n.1 (N.D. Cal. 1991)); *In re Silicon Graphics*, 183 F.3d at 986; *In re Splash*, 160 F. Supp. 2d at 1081. Here, the SAC does not contain any allegations indicating that the Individual Defendants' trading practices were dramatically out of line with their prior practices. (*See* SAC ¶¶ 24, 37, 154-70.) Further, Defendants have presented the Individual Defendants' Forms 4 and 5 filed with the Securities and Exchange Commission beginning in February 1992 to February 1998 which suggest the Defendants' stock sales during the Class Period were consistent with the pre-Class Period sales. (*See* Defs' Req. for Jud. Ntc. Exhs. E-K.) Accordingly, the allegations do not meet the requirements for pleading scienter based on stock sales as required under *Silicon Graphics*.[1]

1. The SAC also relies on Black-Scholes options valuation as evidence that the timing of the Individual Defendants' stock sales

(Cont'd)

B. Statements Regarding Spiros Drug Delivery System.

Plaintiffs allege that Dura made numerous misrepresentations regarding Dura's Albuterol Spiros drug delivery technology. In particular, Plaintiffs contend that Defendants

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was suspicious. The Black-Scholes model is used to calculate the value of stock options. (SAC ¶ 158.) Plaintiffs state this formula demonstrates that "a rational investor in an environment of efficient markets, relying solely upon public information, would not exercise an option to purchase a non-dividend paying stock prior to the expiration date of the option . . . [because] early exercise of an option to purchase forfeits the time value of the option between the date of exercise and the date the option expires." *Id.* Plaintiffs contend that the Ninth Circuit has relied on this model, holding that non-marketable options are to be evaluated using established financial methods such as the Black-Scholes formula. (Oppo. at 33-35 (*citing Custom Chrome v. Commissioner of Internal Revenue*, 217 F.3d 1117, 1124 n. 10 (9th Cir. 2000)).

But *Custom Chrome* is inapposite. That case involved a taxpayer's appeal of the tax court's determination that the warrants issued by it to its lender in connection with a loan transaction had no value, so the taxpayer was not entitled to a deduction. The facts of *Custom Chrome* are therefore distinguishable and the case does not suggest that the Black-Scholes model can or should be used to establish scienter in a securities fraud case. Plaintiffs have not cited, nor has the Court found, any cases applying the Black-Scholes model to cases such as this one. Further, the probativeness of the Black-Scholes model to establish scienter is questionable because it does not consider — as *Silicon Graphics* states is appropriate to consider — the individual circumstances of the insider. Accordingly, the SAC's allegations regarding the Black-Scholes model do not support an inference of scienter.

touted the capabilities of its Spiros drug delivery technology in Dura's 1996 annual report, and when announcing better than expected Q1 1997 results, stated that it was continuing to develop its Spiros Albuterol product. (SAC ¶¶ 55, 56.) Plaintiffs allege that as a result of these statements, Dura's stock soared from $\$27^{7}/_{8}$ on April 14, 1997, to $34 on April 15, 1997. (SAC ¶ 57.)

On April 15, 1997, Oppenheimer & Company, Inc. ("Oppenheimer"), Alex. Brown, Robertson Stephens & Co. ("Robertson Stephens"), and William Blair issued reports on Dura and the development of Spiros that were based on and repeated information provided in an April 15, 1997 conference call with securities analysts in conjunction with the 1996 Annual Report and press release and in follow-up conversations with Garner or Newman. (SAC ¶ 71.) These reports stated that Spiros' development was on track and would soon be completing clinical trials. (SAC ¶ 71.) Shortly thereafter on April 24, 1997, Oppenheimer issued a report on Dura based on and repeated information concerning Dura's Spiros development provided in conversations with Garner and Newman that stated that Albuterol Spiros would be submitted to the FDA before the end of the year. (SAC ¶ 72.) On April 28, 1997, UBS issued a report on Dura that was based on and repeated information concerning Dura's Spiros development provided in conversations with Dura executives, including Garner or Newman, that stated that Spiros was allowing Dura to differentiate itself from a typical marketing company and the Company would become more "fully integrated" through the development of the Spiros inhaler. (SAC ¶ 73.) The report also stated that the company would file the NDA in the second half 1997 and expected it to be

approved in the second half of 1998, with Spiros revenues adding about $58 million to Dura's current sales base in 1999. *Id.* On May 8 and May 30, 1997, Vector issued similar reports stating that Dura was still on track to submit its first Spiros NDA filing in the second half of 1997. (SAC ¶¶ 75, 76.) On May 30, 1997, Alex. Brown also reported that Dura would file its NDA for Albuterol Spiros in the second half of 1997 that could add $100 million in revenues by 2000. (SAC ¶ 76.)

Plaintiffs maintain Dura's June 5, 1997 press release announcing the completion of clinical trials necessary for a NDA submission for Albuterol Spiros was false and misleading. (SAC ¶ 79.) In that release, David S. Kabakoff, Dura's Executive Vice President and President and CEO of Spiros Corp. stated Dura was pleased with the results to date and was preparing the NDA for fling in the latter half of 1997. *Id.* On June 30, 1997, William Blair reported that Newman had stated at an investment conference that Dura planned to file the Albuterol Spiros NDA by fall of 1997 and that the Company was continuing to develop the Spiros product line aggressively. (SAC ¶ 82.) On July 15, 1997, Dura reported better-than-expected Q2 1997 results in a press release, and reiterated that the Company was on track to file the Albuterol Spiros NDA in the second half of 1997. (SAC ¶ 85.) Also on that date, five analysts issued reports on Dura that were based on and repeated information provided in a conference call and in follow-up conversations with Garner and Newman. (SAC ¶ 94.) The analysts reported Dura was on track to file the Albuterol Spiros NDA in the second half of 1997, that Albuterol Spiros could be on the market in late 1998 with initial sales of $10 million growing

to over $55 million by 2000, and that Albuterol Spiros would contribute significantly to Dura's long-term revenue and earnings growth. *Id.*

In August 1997, analysts issued reports on Dura that were based on and repeated information from Garner and Newman stating that Spiros possessed significant advantages over alternative inhalers currently marketed or in development, and the launch of Albuterol Spiros in the second half of 1998 would be a watershed event for the Company. (SAC ¶¶ 103-04.) Analysts issued similar positive reports on September 1997 based on discussions with Garner and Newman. (SAC ¶ 105.) On October 8, 1997, Dura reported at the UBS Life Science Conference that the NDA filing for Albuterol Spiros was expected within days. (SAC ¶¶ 106, 108.)

In mid-October, Dura reported better-than-expected Q3 1997 results. (SAC ¶ 111.) Plaintiffs contend that in a conference call and follow-up conversations with analysts, Defendants reiterated that the NDA for Albuterol Spiros would be filed in November 1997, and continued to tout the significance of Albuterol Spiros on the Company's future revenues. (SAC ¶¶ 122, 123.) After Dura reported better-than-expected Q4 1997 results, analysts issued reports based on conversations with Garner or Newman that stated Dura expected the FDA to approve Albuterol Spiros by the end of 1998. (SAC ¶¶ 128, 130-31.) The analysts further reported Dura expected to launch Albuterol Spiros by early 1999, and that the product would be a significant portion of the company's revenue. (SAC ¶¶ 130-31.)

Plaintiffs contend that the statements regarding Albuterol Spiros' development were false and misleading when made because Defendants knew that Dura's NDA for Albuterol Spiros would be rejected by the FDA, Dura would be required to completely redo its Phase III clinical human trials, and that the product would be delayed in reaching the market, if it did reach the market. (SAC ¶¶ 66, 68, 80, 83, 96, 98, 109, 125, 133.) Plaintiffs maintain that Albuterol Spiros was unreliable and plagued by significant electro-mechanical problems that caused over 30% of the inhalers to fail during clinical trials. (SAC ¶¶ 66, 68, 80, 83, 96, 98, 109, 125, 133.) Plaintiffs allege Dura modified the device while the trials were ongoing to address the reliability problems. (SAC ¶¶ 69, 81, 83, 99, 109, 125, 133.)

According to Plaintiffs, Defendants allegedly knew about serious problems with the stability of Albuterol Spiros in 1996 even before Phase III clinical trials began. (SAC ¶¶ 67, 80, 83, 97, 109, 125, 133.) Specifically, Dura found that Albuterol was unstable when aged and subject to clumping which reduced its efficacy when exposed to humidity. (SAC ¶¶ 67, 80, 83, 97, 109, 125, 133.) Plaintiffs state that Defendants also knew about reliability problems plaguing the Spiros device and Albuterol stability problems from a list Bob Eisele, Vice President of Product Development, prepared in October 1996. (SAC ¶¶ 70, 80, 83, 100, 109, 125, 133.) The Eisele list set forth items that needed to be addressed before an NDA could be submitted, and Dura's engineers recommended further development before NDA submission. (SAC ¶¶ 70, 80, 83, 100, 109, 125, 133.) In addition, Plaintiffs allege that Dura representatives, including Defendants Garner and Prettyman, attended a

pre-filing meeting with the FDA in May 1997 where the FDA informed Dura it was concerned with the Spiros device's reliability and with Albuterol's stability. (SAC ¶¶ 80, 83, 101, 109, 125, 133.) Plaintiffs further contend that in October 1997, there was internal dissension in Dura between Defendants about whether to file the NDA for the Spiros device. (SAC ¶¶ 125, 133.)

One of the elements of a Rule 10b-5 cause of action that a Plaintiff must plead and prove is loss causation. 17 C.F.R. § 240.10b-5; Binder, 184 F.3d at 1063. "The causation requirement in Rule 10b-5 securities fraud cases includes 'both transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused the harm.'" Binder, 184 F.3d at 1065 (*quoting McGonigle v. Combs*, 968 F.2d 810, 820 (9th Cir. 1992)). In the Ninth Circuit, loss causation is satisfied where "the plaintiff shows that 'the misrepresentation touches upon the reasons for the investment's decline in value.'" *Id.* at 1066 *(quoting McGonigle*, 968 F.2d 821); *accord Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir. 1996). At the pleadings stage, plaintiffs do not need to meet a strict test of direct causation; they need only show "some causal nexus" between the defendants' misconduct and the plaintiffs' losses. *In re Controlled Data Corp. Sec. Litig.*, 933 F.2d 616, 619 (8th Cir. 1991).

Defendants argue that Plaintiffs fail to show loss causation because there are no allegations that Defendants' purported misrepresentations and omissions about Albuterol Spiros caused or had any relation to the decline in value of

Plaintiffs' investment. Plaintiffs contend they have properly pled loss causation because they have alleged that the stock price on the date of purchase was inflated because of the misrepresentations or omissions and they would not have purchased the stock had they known about Defendants' wrongdoing. These allegations are not sufficient to withstand a motion to dismiss.

The last day of the Class Period in this action is February 24, 1998. On that date, Dura announced an expected future revenue shortfall in 1998 due to "slower Ceclor CD and Nasarel/Nasalide sales and the immediate need to vastly increase the size of Dura's sales force from 270 to over 450 to try to boost sales of existing products." (SAC ¶¶ 32, 134.) As a result, even though the Dow Jones average went up 87.7 points on February 25, 1998, Dura's stock price fell 47%, trading at $39^{1}/_{8}$ on February 24, 1998 to $20^{3}/_{4}$ on February 25, 1998. (SAC ¶¶ 32, 134.) The SAC does not allege that the February 24, 1998, announcement contained any negative information about Albuterol Spiros. Rather, Dura did not announce that the FDA would not approve Albuterol Spiros until nine months later, in November 1998. (SAC ¶ 136.) The SAC does not contain any allegations that the FDA's non-approval had any relationship to the February price drop. Accordingly, the SAC does not explain how the alleged misrepresentations and omissions regarding Albuterol Spiros "touched" upon the reasons for the decline in Dura's stock price. Rather, the decline in Dura's stock price was the result of an expected revenue shortfall. Accordingly, the SAC's allegations regarding Albuterol Spiros are insufficient to state a claim.

C. Statements Regarding Dura's Sales and Business Performance.

Plaintiffs contend that Defendants misrepresented and omitted critical information regarding Dura's sales of its products, specifically Ceclor CD and Nasalide. In addition, Plaintiffs contend that Defendants inflated its revenues by failing to take a write-down on its Rondec product line. Specifically, Plaintiffs allege that on April 15, 1997, Dura announced in a press release better-than-expected Q1 1997 results, stating that revenues for the quarter totaled $40.9 million, net income was $8.8 million, and EPS were $0.19 — a 74% increase from $0.11 in first quarter 1996. (SAC ¶ 56.) Defendants reported that "Dura doubled the Ceclor® CD share of cefaclor weekly from new prescriptions over fourth quarter 1996 to 15%, up from 7.5% at year end. Commenting on this increase, Garner noted 'Since the product launch just 20 weeks ago, our sales representatives have been successfully delivering the message to high prescribing physicians of patient compliance advantages of Ceclor® CD over Ceclor® in the treatment of bronchitis." *Id.* The press release also quoted Garner as stating "[w]e are very pleased with first quarter results . . . we are happy with the strong progress made in selling our new respiratory antibiotic, Ceclor® CD." *Id.* On June 30, 1997, William Blair reported that Defendant Newman announced at the William Blair 1997 Investment Conference that Ceclor CD continued to gain market share, with an approximate 17.9% share of the cefaclor market, versus 16.9% at the end of April and 7.5% at the end of December 1996. (SAC ¶ 82.)

Appendix B

On May 7, 1997, Dura announced it had acquired the Nasarel/Nasalide spray product line from Roche Holding AG. (SAC ¶ 74.) Defendant Garner stated that the Nasarel and Nasalide products fit within Dura's respiratory focus, adding a new respiratory category to the Company's product portfolio. *Id.*

On July 15, 1997, Dura reported better-than-expected Q2 1997 results in a press release, stating that net income for the second quarter totaled $9.3 million, or $0.20 per share on revenues of $43.6 million compared to net income of $4.6 million, or $0.12 per share, on revenues of $18.8 million in the second quarter that ended June 30, 1996. (SAC ¶ 85.) Garner stated the company was pleased with Dura's performance in the second quarter of 1997, and that Ceclor CD and Keftab were well received by physicians who were responding favorably to Dura's promotional efforts. *Id.*

On October 8, 1997, Dura representatives appeared at the UBS Life Science Conference. (SAC ¶ 106.) UBS thereafter reported that Dura presented compelling market share data regarding Ceclor CD's progress in the U.S. cefaclor cephalosporin franchise, and that Ceclor registered nearly a three-point sequential increase in market share between August and September. *Id.* Shortly after the conference, Dura announced better-than-expected 3Q 1997 results, reporting record earnings for both the third quarter and nine months year-to-date of 1997, compared to the same period the previous year. (SAC ¶ 111.) The Company stated that net income for the third quarter totaled $11.3 million, or $0.24 per share, on revenues of $43.3 million compared to net income of $5.8 million, or $0.14 per share, on revenues of $25.9 million for the third quarter ended September 30, 1996.

Appendix B

Id. Dura primarily attributed the increase in revenues to growth in sales of respiratory pharmaceuticals, which rose 91% to $36.1 million in the third quarter of 1997 compared to $18.9 million in the third quarter of 1996. *Id.* The pharmaceutical sales growth was largely due in part to the impact of new product acquisitions and introductions, such as Ceclor CD and Nasarel. *Id.* In a follow-up conference call, Vector reported Dura's management indicated that earnings for 1998 could run in the low $1.40's range. (SAC ¶ 112.)

On January 20, 1998, Dura reported better-than-expected Q4 1997 results, stating revenues were at $53.5 million and $181.3 million for the quarter and the full year, respectively. (SAC ¶ 128.) Excluding one-time charges, Dura would have had a net income of $18.0 million, or $0.37 per share in the quarter, and $47.4 million, or $0.99 per share for the year, compared to a net income of $9.9 million, or $0.22 per share for the fourth quarter of 1996 and $24.3 million, or $0.60 per share for the full year 1996. *Id.* Dura also reported that its sales from pharmaceuticals rose 89% to $150 million in 1997 compared to $79.6 million in 1996, due in part to product acquisitions. *Id.* In a press release, Garner was quoted as stating that the Company's Ceclor CD market share of the oral solid cefaclor market rose from 8% at the beginning of 1997 to 25% by year-end. *Id.*

1. Plaintiffs' Falsity and Scienter Allegations Regarding Defendants' Statements About Sales of its Products.

Plaintiffs contend the Defendants misrepresented Dura's revenues from the sales of its products, particularly Ceclor CD and Nasalide. Plaintiffs allege these statements were false

and misleading because "sales of Dura's major drug products were flat or declining, especially Ceclor CD, whose sales levels were dropping throughout the Class Period." (SAC ¶¶ 58(a), 114(a), 129.) Plaintiffs argue that to cover up the sales shortfalls, Dura artificially inflated its revenues and EPS by shipping excessive amounts of Ceclor CD and other products to wholesalers, who were enticed to take the product by price discounts, extended payments terms and/or other incentives. (SAC ¶¶ 58(d), 86(c), 114(c), 129.) Plaintiffs state that Dura recognized revenue on the sale of a product when it shipped the product to drug wholesalers, who in turn resold the drug to pharmacies, drug chains, or even individual physicians. (SAC ¶¶ 65, 93, 121, 129.) Because Dura did not publicly disclose to analysts or investors sales of each of its various drug products, analysts and investors did not know that Dura was shipping amounts of Ceclor CD to wholesalers well in excess of the amount justified by or necessary to keep pace with current prescription levels. (SAC ¶¶ 65, 93, 121, 129.) As a result, Dura's Ceclor CD and other product inventories in the distribution channel were greatly in excess of the normal one-month supply. (SAC ¶¶ 58(d), 65, 93, 114(c), 121, 129.) Plaintiffs state that these excessive inventory levels would eventually have to be worked off, causing sales and earnings to drop. (SAC ¶¶ 65, 93, 114(c), 121, 129.)

Plaintiffs' allegations regarding Nasalide are conclusory and insufficient. Plaintiffs allege that Nasalide sales were "poor and well below expectations," (SAC ¶ 86(d), ¶ 114(d), 129), but they do not specify facts or evidence to support this contention. As the Ninth Circuit noted in *Ronconi v. Larkin*, 253 F.3d 423, 431 (9th Cir. 2001), "[i]t is not sufficient

simply to allege that a statement was false. Plaintiffs must state with particularity all facts upon which their beliefs]" are based.

Plaintiffs' allegations regarding Ceclor CD sales have more specificity in that Plaintiffs contend that monthly sales reports showed that Ceclor CD sales began dropping around March-April 1997, and significantly worsened during summer of 1997. (SAC ¶¶ 63, 119, 129.) As a result, according to Plaintiffs, the reports showed that sales were 25-40% below internal projections at that time. (SAC ¶¶ 63, 119, 129.) Monthly sales reports showed that Ceclor CD sales dropped from 47,288 in March 1997 to 39,808 in May 1997 to 24,797 in July 1997. (SAC ¶¶ 63, 119, 129.) But as this Court found in its earlier order, "[t]he mere fact that intraquarterly results lagged behind internal projections does not, without more, require disclosure." *Glassman v. Computervision Corp.*, 90 F.3d 617, 631 (1st Cir. 1996). Further, the SAC allegations regarding Ceclor are conclusory in that while Plaintiffs allege the Company was shipping amounts of the product "well in excess of the amount justified by or necessary to keep pace with current prescription levels and thus Dura had created vastly excessive amounts of inventory of Ceclor CD in the distribution channel," (SAC ¶¶ 65, 93), the SAC does not provide any factual support on how Defendants knew at the time the distribution channels were clogged. Rather, Plaintiffs state that after the Class Period ended, Dura admitted there was excessive inventory of Ceclor CD. (SAC ¶¶ 34, 135.) As with the SAC's allegations regarding Dura's sales force, post-Class Period statements are not sufficient to indicate that the Defendants' statements regarding Ceclor sales during the Class Period

were false and made with knowledge of their falsity. *See In re GlenFed*, 42 F.2d at 1548 (stating that a complaint cannot demonstrate that a statement was false or misleading when made "merely by pointing to later inconsistent statements or conditions"); *DeMarco*, 149 F. Supp. 2d at 1223.

In addition, Plaintiffs' allegations that Defendants knew their statements regarding Dura's revenues from sales were false when made are deficient. First, the SAC's allegations of scienter based on insider stock sales fail for the reasons discussed above in section II.A. Plaintiffs also allege scienter based on Defendants being "hands on" managers who attended weekly management meetings from 8:00 a.m. to 10:00 a.m., and constantly monitored and were informed about the sales of Dura's core products via various internal reports, meetings, and conversations with corporate officers and employees. (SAC ¶¶ 59-62, 64, 87-90, 115-18, 120, 129.) These allegations are not sufficient because they do not identify specific reports, specific information contained in those reports, specific conversations, or specific meetings. *See In re Splash*, 160 F. Supp. 2d at 1079-81 (holding that allegations of scienter based on unspecified corporate documents, unspecified conversations with corporate officers and employees, attendance at unspecified meetings, and unspecified communications with customers were insufficient); *In re Autodesk*, 132 F. Supp. 2d at 843-44 (holding that "plaintiffs must do more than allege that these key officers had the requisite knowledge by virtue of their 'hands on' positions, because that would eliminate the necessity for specially pleading scienter, as any corporate officer could be said to possess the requisite knowledge by virtue of his or her position"); *In re Read-Rite*, 115 F. Supp.

2d at 1185 (stating that "[o]ne *reasonably* could infer that persons with [defendants'] job titles would be aware of major developments concerning a key customer's refusal to implement a major product line. However, under current law, the mere existence of a reasonable inference does not satisfy the Reform Act's requirement of a strong implication).

Further, as this Court found in dismissing the earlier complaint, channel stuffing allegations are insufficient for scienter. Channel stuffing "is the oversupply of distributors in one quarter to artificially inflate sales, which will then drop in the next quarter as distributors no longer make orders while depleting their excess supply." *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1298 (9th Cir. 1998). The First Circuit has held that [t]here is nothing inherently improper in pressing for sales to be made earlier than in the normal course." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 202 (1st Cir. 1999). Although Plaintiffs' "channel stuffing" claims may have some probative value insofar as the channel stuffing was done so as to artificially inflate income, "that value is weak." *Id.* at 202-03. Because there may be a number of legitimate reasons for attempting to achieve sales earlier, "channel stuffing" claims "do not support a strong inference of scienter." *Id.* at 203. Indeed, this Circuit has rejected "channel stuffing" claims. *Steckman*, 143 F.3d at 1298. In *Steckman*, the Ninth Circuit stated that *"[t]his claim is speculation made in hindsight." Id.* (emphasis added).

Accordingly, Plaintiffs' allegations that Dura misrepresented its sales because sales of its products were not as robust as stated are insufficient to withstand a motion to dismiss.

2. Sufficiency of Plaintiffs' Falsity and Scienter Allegations Regarding Defendants' Statements About Rondec.

Plaintiffs contend that Dura misrepresented its revenues because the Rondec and Dura-Vent product lines were suffering very poor sales. (SAC ¶¶ 58(e), 86(e), 114(e). Plaintiffs maintain sales of these products were declining so rapidly and performing so poorly that Dura would not be able to recover its remaining investment in Rondec from those sales. (SAC ¶¶ 58(e), 86(e), 114(e).) Plaintiffs contend that Dura falsified and artificially inflated its Q1 1997 EPS by failing to take required write-downs on the carrying value of its investment in the Rondec product line, which were required because the sales of the product line had so declined and were so poor that Dura could not recover its remaining investment in Rondec. (SAC ¶¶ 58(f), 86(f), 114(f)).

In brief, Plaintiffs' claim regarding Rondec is that Defendants violated GAAP in its valuation. Violations of GAAP standards can provide evidence of scienter. *Greebel*, 194 F.3d at 203; *see In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1273 (N.D. Cal. 2000) ("However, when significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter. After all, books do not cook themselves.") "To support even a reasonable inference of scienter, however, the complaint must describe the violations with sufficient particularity; 'a general allegation that the practices at issue resulted in a false report of company earnings is not a sufficiently particular claim of misrepresentation.'" *Greebel*, 194 F.3d at 203 (*quoting Gross v.*

Summa Four, Inc., 93 F.3d 987, 996 (1st Cir. 1996)). When contending that a write-down was done too late, "[t]he pleading must provide some particularized support regarding inventory levels, the defendants' knowledge, and approximately when plaintiffs think the write-down should have occurred." *In re Petsmart*, 61 F. Supp 2d at 993. Here, Plaintiffs contend that Dura should have recorded an impairment charge for the Rondec investment or accelerate the amortization of the asset sales of Rondec because sales of that product were low, (SAC ¶ 145), but fail to allege particularized facts regarding Rondec's inventory levels. Nor does the SAC give any factual support for how the timing of the Rondec charge was unusual or reckless or give any specificity as to when the Defendants knew it should have been done.

Moreover, like the announcement of the FDA's non-approval of Albuterol Spiros, the $28 million charge Dura took for Rondec did not occur until after the Class Period ended. (*See* SAC ¶ 145.) While the SAC does not specify the date when the charge was taken, it alleges the charge occurred sometime after the December 1998 reconsolidattion of DJ Pharma back into Dura. *Id.* Notably, however, Plaintiffs have not alleged how the write-down "touched upon" the February 1998 drop in Dura's stock price. The February 24, 1998 announcement that precipitated the the drop in Dura's stock price concerned a revenue shortfall due to slower Ceclor CD and Nasarel/Nasalide sales and the immediate need to increase the size of Dura's sales force. (SAC ¶¶ 32, 134.) There are no allegations indicating the announcement contained any information about Dura's investment in Rondec. Accordingly, Plaintiffs' allegations

regarding Rondec fail for the alternative reason that Plaintiffs have not properly alleged loss causation as to the Rondec misrepresentations and omissions. *See Binder*, 184 F.3d at 1066 (holding that loss causation is satisfied where "the plaintiff shows that the 'misrepresentation touches upon the reasons for the investment's decline in value'" (*quoting McGonigle*, 968 F.2d 821); *accord Provenz*, 102 F.3d at 1492); *In re Controlled Data*, 933 F.2d at 619 (holding that at the pleadings stage, plaintiffs must allege "some causal nexus" between the defendants' misconduct and the plaintiffs' losses).

III. Section 20(a) Claim.

Rule 20(a) of the 1934 Securities and Exchange Act provides for controlling person liability for every person who, directly or indirectly, controls any person liable under any of the provisions of this title. 15 U.S.C. § 78t(a). To establish control person liability, however, a plaintiff must show that a primary violation occurred. *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1252 (N.D. Cal. 1998). Accordingly, because Plaintiffs' § 10(b) claim is being dismissed, their claim under § 20(a) is dismissed as well.

IV. Defendants' Request for Judicial Notice.

Defendants have requested the Court take judicial notice of various press releases, Dura's l0K and l0Q forms. Plaintiffs have not challenged this request. Accordingly, Defendants' request is **GRANTED** insofar as the Court has relied on those documents for its analysis, it takes judicial notice of them under Federal Rule of Evidence 201.

CONCLUSION

Having reviewed the SAC, the parties' briefs and oral argument, applicable law, and good cause appearing, **IT IS HEREBY ORDERED.**

1. Defendants' motion to dismiss is **GRANTED.**

2. Because the Plaintiffs have had an opportunity to amend the complaint to meet the pleading requirements under the PSLRA and *Silicon Graphics*, the Second Consolidated and Amended Complaint is **DISMISSED WITH PREJUDICE.**

3. Defendants' request for judicial notice is **GRANTED** insofar as the Court has relied on those documents.

4. The Clerk of the Court is directed to enter judgment in this action, and the judgment shall apply to all matters that have been consolidated to the instant master file, *In re Dura Securities Litigation*, 99cv0151-L(NLS).

IT IS SO ORDERED.

Dated: 11/2/01

s/ M. James Lorenz
M. JAMES LORENZ
UNITED STATES DISTRICT JUDGE

APPENDIX C — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT DENYING PETITION FOR REHEARING AND REHEARING EN BANC DATED SEPTEMBER 25, 2003 AND FILED SEPTEMBER 29, 2003

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 01-57136

MICHAEL BROUDO,

Plaintiff/Appellant,

v.

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Defendants/Appellees.

ORDER

Before: PREGERSON, REINHARDT, and ARCHER,[1] Circuit Judges.

The panel has voted to deny appellees' petition for rehearing and to ~~reject~~ the suggestion for rehearing en banc.

1. Honorable Glann L. Archer, Jr., Senior United States Circuit Judge for the Federal Circuit, sitting by designation.

Appendix C

The full court was advised of the suggestion for rehearing en banc. No judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P.35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

APPENDIX D — STATUTE INVOLVED

15 U.S.C. § 78u-4

* * *

(b) Requirements for securities fraud actions

* * *

(4) Loss causation

In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

* * *

(e) Limitation on damages

(1) In general

Except as provided in paragraph (2), in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the

purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception

In any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.

* * * *

Supreme Court, U.S.
FILED
FEB 4 - 2004
OFFICE OF THE CLERK

No. 03-932

IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; and BRENT VOGT, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

RESPONSE IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether this Court should grant certiorari to decide a question on which there is little, if any, real disagreement among the circuits, and the resolution of which makes no difference on the facts of this case.

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IN THE

Supreme Court of the United States

No. 03-932

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

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v.

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Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

RESPONSE IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

INTRODUCTION

This is a case in which investors allege that they paid too much for common stock of Dura Pharmaceuticals because Dura and its top officers—the defendants below and petitioners before this Court—had deliberately deceived the market in two respects. First, the plaintiff investors contend that Dura led the market to believe that its existing products—including one called Ceclor—were selling better than they really were. Second, the investors contend that

Dura misled the market about the prospects of a new drug-delivery product called Albuterol Spiros, for which it was seeking approval from the Food and Drug Administration ("FDA").

As to the first set of misrepresentations, about demand for and sales of existing products, Dura's stock price collapsed by around 47% in a single day following the company's February 24, 1998, admissions regarding slow sales and a resulting revenue shortfall for the upcoming year. Petition at 2. As to the second set of misrepresentations, about Albuterol Spiros, petitioners acknowledge in a footnote that Dura's stock price similarly declined by more than 21% "from $12.375 to $9.75" following a November 3, 1998, announcement that the FDA had refused approval, citing serious problems with the product. Petition at 3 n.4.

Not surprisingly, the Ninth Circuit held that in light of the materiality of the misrepresentations alleged, and the resulting inflation in the price of Dura stock, plaintiffs who purchased the stock at inflated prices only to see it decline on disclosure of the truth had adequately alleged loss causation to proceed with a claim under § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"). It rejected defendants' contention that a portion of plaintiffs' case should be dismissed under Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim upon which relief may be granted.

Petitioners do not challenge the Ninth Circuit's holding that plaintiffs should be permitted to proceed on claims related to alleged misstatements and omissions about demand and sales. Before this Court, they challenge plaintiffs' case *only* as it relates to false statements about Albuterol Spiros and whether those statements may have caused plaintiffs any loss. At this stage of the case, of course, a connection between injury and loss ordinarily is presumed. *See NOW v. Scheidler*, 510 U.S. 249, 256 (1994); *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 561 (1992).

Petitioners nonetheless contend that the case requires this Court's review at this preliminary stage of the proceedings, to resolve purported conflicts among the circuits on proof of "loss causation" in securities cases. Asking this Court to focus its attention only on alleged misrepresentations and omissions covering Albuterol Spiros, petitioners start by asserting that plaintiffs failed to establish any connection between those misrepresentations and the 47% February 1998 decline in Dura's stock, on announcement that sales were not as good as petitioners had led investors to believe—as if the later 21% decline in the stock, on announcement of the new product's failure before the FDA, never took place. Ignoring the rest of plaintiffs' case, petitioners contend that Ninth Circuit law on loss causation conflicts with that of other circuits, because the Ninth Circuit did not expressly require plaintiffs to plead that the later 21% decline in price on adverse disclosures about Albuterol Spiros's demise before the FDA. Petitioners insist that other circuits would have required plaintiffs to plead more clearly that representations about Albuterol Spiros "touched upon" reasons for the decline.

Although the Ninth Circuit did not focus on it, the conceded fact of the 21% decline, tied to adverse revelations about Albuterol Spiros, means that any conflict among the circuits is of no consequence on the facts of this case. "Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price," might be an interesting question in the abstract, or in a case where it made a difference on the facts presented. But it really is not one presented for decision on the facts of this case, where the security's price clearly did decline upon the relevant disclosure. *See infra* at 4-6. Moreover, on close inspection the purported "conflict" among the circuits

comes to far less than petitioners suggest—amounting more to differences in semantics than in fundamental principles. This Court's review is not needed. *See infra* at 7-14.

Finally, citing the Private Securities Litigation Reform Act of 1995's enactment of a new Exchange Act § 21D(e)(1), petitioners say "the Ninth Circuit's theory of loss causation is not practically viable in light of the Reform Act's explicit limitation on damages, which defines a plaintiffs' loss in terms of a post-transaction decline in stock price." Petition at 7. If petitioners are right that the Ninth Circuit's holding is not "practically viable" when Exchange Act § 21D(e)(1) is properly invoked, it is by no means clear why this Court's review should be needed to apply a provision neither argued nor cited below. Nor is it apparent that applying § 21D(e)(1) could affect the outcome in this case. In any event, it is an issue that petitioners never raised before the Ninth Circuit, and that gives this Court no reason to grant a writ of certiorari. *See infra* at 14-15.

ARGUMENT

I. PETITIONERS' "QUESTION PRESENTED" IS IRRELEVANT ON THE FACTS OF THIS CASE

Petitioners say this Court's review is needed because the circuits are in conflict on the question they wish to present: "Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price." Petition at i. Petitioners say that the Ninth Circuit differs from several other circuits because it imposes no requirement that investors alleging market manipulation and fraud *ever* attribute a decline in their securities' price to defendants' fraud in order to show that the fraud in fact caused their loss.

Assuming that were so, what impact would it have on the facts of this case? Petitioners never say—for it would have none at all. Dura's stock declined 47% in response to defendants' February announcement of weak demand and poor sales, and it declined 21% on defendants' November announcement that the FDA could not approve Albuterol Spiros. *See* Petition at 3 & n.4.

Petitioners make much of the fact their announcement triggering a 47% stock drop in February had nothing to do with their misrepresentations about Albuterol Spiros. Petitioners insist that because misrepresentations about Albuterol Spiros could not have triggered the 47% drop, plaintiffs cannot show that fraudulent statements about Albuterol Spiros caused this loss.

So what? Even if investors must in every case show a drop in a security's price upon disclosure of the truth, petitioners concede—albeit in a footnote—that in fact "Dura's share price declined somewhat following the November 3 announcement, from $12.375 to $9.75." Petition at 3 n.4. That amounts to a one-day drop of more than 21% on announcement that Albuterol Spiros failed before the FDA. "Somewhat" of a decline, indeed.

Thus, even if proof of such a decline is not strictly necessary in every securities case pursued in the Ninth Circuit, and even if the Ninth Circuit law on this point diverges somewhat from other authorities, that really would make no difference at all on the facts of this case. The facts simply do not present, for this Court's resolution, the issue on which petitioners seek review—to resolve a purported "conflict" among the circuits.

Even if the Ninth Circuit's opinion does not demand that the plaintiffs plead the 21% decline, moreover, that dramatic drop in market value still is a part of plaintiffs' case—which they will use to prove their claims. Petitioners point to

Exchange Act § 21D(b)(4), which says that at trial "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate [the Exchange Act] caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). That is exactly what plaintiffs will do, on remand from the Ninth Circuit.

Petitioners suggest that allowing plaintiffs to do so somehow runs afoul of new pleading requirements enacted by the Private Securities Litigation Reform Act of 1995. They say "Congress sought, in part, to establish uniform and stringent pleading requirements in securities fraud actions arising under Section 10(b) of the Securities Exchange Act of 1934." Petition at 15. But those requirements are contained in Exchange Act § 21D(b)(1) and (2), which require investors both to identify the statements they contend are false along with the reasons why they are false, and also to plead facts raising a strong inference of scienter. 15 U.S.C. § 78u-4(b)(1), (2). Section 21D(b)(3) provides that if these pleading requirements are not met, the case shall be dismissed, imposing a discovery stay during the pendency of any motion to dismiss. 15 U.S.C. § 78u-4(b)(3).

Subsection (4) then provides that *after* surviving motions challenging the pleadings under the foregoing subsections, "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). This loss-causation requirement, by its terms, imposes no new pleading burden, but merely a "burden of proving"—at trial—that defendants' wrong caused plaintiffs' loss. Again, that is something to be done on remand from the Ninth Circuit. It is not an issue for this Court—certainly not at this stage of the case.

II. PETITIONERS' "CONFLICT" AMONG THE CIRCUITS AMOUNTS TO LITTLE

Petitioners' supposed "conflict" among the circuits amounts to far less than petitioners suggest. For the circuits agree on fundamentals, and differences among them appear to be more a matter of semantics than substantive legal principles.

As this Court has repeatedly stated, investors induced by fraud to purchase a security ordinarily are entitled under § 10(b) to recover their out-of-pocket loss, which is simply "'the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct.'" *Randall v. Loftsgaarden,* 478 U.S. 647, 661-62 (1986) (quoting *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 155 (1972)). Still, the rule is by no means a rigid one: "'While out of pocket loss is the ordinary standard in a 10b-5 suit, it is within the discretion of the district judge in appropriate circumstances to apply a rescissory measure,'" for example. *Randall v. Loftsgaarden,* 478 U.S. at 662 (quoting *Blackie v. Barrack,* 524 F.2d 891, 909 (9th Cir. 1975)). Relevant concepts of loss, and loss causation, may vary from one case to the next, depending on all the facts presented. *See id.*

Despite petitioners' cries of "conflict," the circuits clearly agree that the recoverable loss in securities-fraud cases typically will be "out of pocket loss," or the difference between the price paid and the value of a security received—as this Court stated in *Affiliated Ute*, 406 U.S. at 155, and *Randall v. Loftsgaarden*, 478 U.S. at 661-57.[1] The circuits

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[1] *See, e.g., Ambassador Hotel Co. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1030 (9th Cir. 1999); *Farley v. Henson*, 11 F.3d 827, 837 (8th Cir. 1993); *Stone v. Kirk*, 8 F.3d 1079, 1092 (6th Cir. 1993); *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1336 (8th Cir. 1991), *aff'd on other grounds*, 507 U.S. 170 (1993); *Astor Chauffeured Limosine Co. v. Runnfeldt Inv. Corp.*,

agree as well that *if* investors point to a decline in price as the loss that they suffered, then the investors must eventually show that the fraud they prove at least "touches upon" the reasons for the decline.

While petitioners' argument suggests that the Ninth Circuit holds otherwise, nothing could be further from the truth. It has held more than once that when investors point to a decline in a security's market price as their "loss," they must connect that price decline to the fraud they allege. *See, e.g., Binder v. Gillespie,* 184 F.3d 1059, 1065-66 (9th Cir. 1999); *Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir. 1996); *McGonigle v. Combs,* 968 F.2d 810, 820-21 (9th Cir. 1992). Petitioners somehow overlook these decisions even though the opinions below both cite and even quote from them. *See, e.g.*, Appendix at 8a, 39a.

In *McGonigle*, the Ninth Circuit rejected contentions that § 10(b) plaintiffs could recover the decline in a security's value that had nothing to do with the misrepresentations they alleged. The Ninth Circuit adopted as its own the rule stated in *Huddleston v. Herman & MacLean,* 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds,* 459 U.S. 375 (1983):

> As the Fifth Circuit stated in *Huddleston*, 640 F.2d at 549, "the plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value."

McGonigle, 968 F.2d at 821 (quoting *Huddleston,* 640 F.2d at 549).

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910 F.2d 1540 (7th Cir. 1990); *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971).

Thus the Ninth Circuit has in fact embraced, and followed, the very rule from *Huddleston* that petitioners say it rejects. Petitioners say: "The majority of Circuits that have explicitly addressed loss causation, including the Second, Third, Seventh, and Eleventh, have adopted an interpretation similar to that set forth in *Huddleston,* while the Eighth and Ninth Circuits have applied a very different rule." Petition at 7. But in *McGonigle* the Ninth Circuit clearly applied *Huddleston. See McGonigle*, 968 F.2d at 821.

The Ninth Circuit applied the rule from *Huddleston* in *Binder* as well, writing: "The loss causation requirement, equivalent to proximate causation in tort, is satisfied if the plaintiff shows that 'the misrepresentation touches upon the reasons for the investment's decline in value.'" *Binder,* 184 F.3d at 1066 (quoting *McGonigle,* 968 F.2d at 821 (quoting *Huddleston,* 640 F.2d at 549)). "That is," the Ninth Circuit explained, "the plaintiff must show that the fraud caused, or at least had something to do with, the decline in the value of the investment after the securities transaction took place." *Binder,* 184 F.3d at 1066. The court affirmed summary judgment against an investor who could not relate any misleading statements to the decline that he claimed as his loss. *See id.*; *see also Ambassador Hotel Co. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1027 (9th Cir. 1999) (applying *Huddleston*'s "touches upon" formulation); *Provenz*, 102 F.2d at 1492 (same).

Although petitioners insist that Ninth Circuit law conflicts with the Eleventh Circuit's decision in *Robbins v. Koger Properties, Inc.,* 116 F.3d 1441 (11th Cir. 1997), the Ninth Circuit's decision in *Binder* actually cites *Koger Properties* as a decision "noting the important distinction between loss causation and the proof of damages." *Binder,* 184 F.3d at 1066.

In *Koger Properties,* the plaintiff investors contended—at trial—that a given decline in price provided the measure of their loss, but they could show no connection between the

decline and the fraud alleged. Petitioners aptly summarize the decision: "Because the plaintiffs were unable to show that the drop in stock price was related to the alleged misrepresentation, the court of appeals held that the plaintiffs had failed to satisfy the loss causation requirement." Petition at 9 (citing *Koger Properties,* 116 F.3d at 1446, 1448-49). That obviously is quite similar to the Ninth Circuit's holding in *Binder* and *McGonigle*. Any "conflict" among the circuits on this point appears to be rather insignificant. Perhaps that is why the Petition does not so much as cite *Binder* and *McGonigle.*

Nor do petitioners acknowledge that the decision below cites the standard from *Huddleston* that they say the Ninth Circuit rejects: "In this circuit, loss causation is satisfied where 'the plaintiff shows that "the misrepresentation touches upon the reasons for the investment's decline in value."'" Appendix at 8a (quoting *Binder*, 184 F.3d at 1066 (quoting *McGonigle*, 968 F.2d at 821)). The decision below then states another point that petitioners somehow miss: "This 'touches upon' language is admittedly ambiguous." Appendix at 8a. What it ultimately means—and requires—depends upon factual context, and the nature of the fraud alleged. Appendix at 8a-9a. For the connection between fraud and loss may be proved in more than one way. *See Blackie v. Barrack*, 524 F.2d at 909 n.25.

Nor does *Semerenko v. Cendant Corp.,* 223 F.3d 165 (3d Cir. 2000), help petitioners to show a meaningful conflict among the circuits. "In the absence of a correction in the market price," the Third Circuit wrote in dictum, "the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price." *Id.* at 185. Even as summarized by petitioners, the Third Circuit's holding is entirely consistent with the result in this case. Petitioners write: "Because the plaintiffs had not only alleged

that they purchased shares at an inflated price, but also alleged that the price of their stock declined when the corrective disclosure was made known to the public, the court concluded that the complaint alleged sufficient facts to establish loss causation." Petition at 10. Petitioners cannot dispute the fact that, here too, "Dura's share price declined somewhat following the November 3 announcement, from $12.375 to $9.75." Petition at 3 n.4.

Much the same may be said of *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group Inc.,* 343 F.3d 189 (2d Cir. 2003), in which the Second Circuit held that allegations of a "'pump and dump' scheme"—in which defendants allegedly inflated a security's market price so that they could sell shares before it fell—provided a sufficient connection between the defendants' misstatements and the plaintiffs' loss. *Id.* at 197-98. "Because the second amended complaint may be read as alleging that NETV was a 'pump and dump' scheme," the Second Circuit held, "appellant has adequately alleged loss causation for the purposes of its federal securities fraud claims." *Id.* at 198.

Petitioners identify no discernible conflict between this holding and the law of any other circuit. Rather, they look to *obiter dictum* in *Emergent* discussing the Second Circuit's prior decision in *Suez Equity Investors L.P. v. Toronto-Dominion Bank,* 250 F.3d 87 (2d Cir. 2001). But *obiter dictum* is just that—dead words, not law. Any inconsistency between *Emergent*'s dictum on the one hand, and *Suez Equity* or even the decision below, on the other, is something that the lower courts can deal with. It hardly requires this Court's intervention. As the Seventh Circuit observed when it addressed loss caustion in *Bastian v. Petren Resources Corp.*, 892 F. 2d 680, 685 (7th Cir. 1990), "such conflict as there is appears to be within rather than among circuits." And even

then, "cases that express disagreement" in all likelihood remain reconcilable—reflecting *differing facts* rather than *differing doctrines*. *Id.* at 685-86.

In *EP MedSystems, Inc. v. Echocath, Inc.*, 235 F.3d 865 (3d Cir. 2000), for example, the Third Circuit noted semantic differences between its *Semerenko* decision—on which petitioners now rely—and earlier Third Circuit decisions. The Third Circuit brushed linguistic inconsistencies aside, joining other circuits in their "practical approach" to loss causation—focusing on the facts of each case rather than on the verbal formulae framed to deal with each unique situation. The Third Circuit explained:

> Some of the other courts of appeals have also adopted a practical view of loss causation. For example, the Eighth Circuit has stated that "plaintiffs are not required to meet a strict test of direct causation under Rule 10b-5; they need only show some causal nexus between [the defendant's] improper conduct and plaintiff's losses." *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619 (8th Cir. 1991) (quotation omitted). The Second Circuit similarly held that loss causation "embodies notions of the common law tort concept of proximate causation." *AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 216 (2d Cir. 2000) (quotation omitted). *In Ambassador Hotel Co., Ltd. v. Wei-Chuan Investment*, 189 F.3d 1017, 1027 (9th Cir. 1999), the Ninth Circuit stated that "the loss causation requirement limits the ability of plaintiffs to recover for losses sustained on the basis of factors unrelated to any misrepresentation or fraud." As the Eleventh Circuit stated in *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997), "the loss causation requirement must be applied on a case-by-case basis."

EP MedSystems, 235 F.3d at 884. These are, of course, the very circuits that petitioners insist are in purported "conflict."

What is more, the Third Circuit emphasized, "[t]he causation issue becomes most critical at the proof stage." *Id.* "Whether the plaintiff has proven causation is usually reserved for the trier of fact." *Id.* at 884-85 (citing *Huddleston*, 640 F.2d at 549-50 as reversing for failure to submit causation to the jury). "MedSystems' complaint," the Third Circuit emphasized, "was dismissed at the pleading stage." *Id.* at 885. "Although, as noted above," the Third Circuit continued, "the allegation that it 'sustained substantial financial losses as a direct result of the aforementioned misrepresentations and omissions on the part of EchoCath' could have more specifically connected the misrepresentation to the alleged loss, *i.e.*, investment in a company with little prospects, when we draw all reasonable inferences in plaintiff's favor, we conclude that MedSystems has adequately alleged loss causation." *Id.* For at the pleading stage, the connection between alleged wrongdoing and loss may be assumed. *See NOW v. Scheidler*, 510 U.S. at 256; *Lujan*, 504 U.S. at 561.

This case presents no fundamental conflict at all. When all is said and done, the decisions that petitioners cite conflict not in the fundamental principles at stake, but—at most—merely in semantic dicta. Dicta in the decision below suggests that "other circuits are less favorable to plaintiffs" because they demand "demonstration of a corrective disclosure followed by a stock price drop," when the Ninth Circuit might not always require this. Appendix at 9a n.4. Dicta in *Koger Properties* suggests that the Ninth Circuit may be more liberal than the Eleventh Circuit when plaintiffs seek to recover as their loss a decline in their security's price that they cannot connect to any of defendants' alleged misstatements. *Koger Properties*, 116 F.3d at 1448.

But it takes more than trifles like that, making no difference at all on the facts presented, to warrant issuing a writ of certiorari.

III. THE EXCHANGE ACT'S STATUTORY "LOOK-BACK" PROVISION NEITHER WAS RAISED BELOW, NOR HAS ANY APPARENT IMPACT ON THE FACTS OF THIS CASE

Petitioners make much of Exchange Act § 21D(e)(1), which was enacted by the Private Securities Litigation Reform Act of 1995, and provides that

> in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

15 U.S.C. § 78u-4(e)(1).

Although they never even so much as cited this provision before the Ninth Circuit, petitioners say it now requires this Court to review the decision below. In fact, this Court seldom should be called upon to resolve matters, well within the competence of a lower court, that litigants chose not to raise below. *See Delta Air Lines, Inc. v. August*, 450 U.S. 346, 362 (1981); *Adickes v. S. H. Kress & Co.*, 398 U.S. 144, 147 n.2 (1970).

Had petitioners cited it, the Ninth Circuit might well have observed that the provision has little relevance on the facts of this case—facts that, once again, petitioners prefer to ignore. For the provision in question provides merely that damages "shall not exceed the difference between the purchase . . . price paid . . . by the plaintiff for the subject security and the mean trading price of that security" following full disclosure of the truth. 15 U.S.C. § 78u-4(e)(1). Here, the four named plaintiffs who purchased common stock all paid from $36.35

to $45.35 apiece for their shares. ER72:¶¶ 41-46. The stock collapsed dramatically in February on disclosure of poor sales, and again in November on disclosure of Albuterol Spiros's failure with the SEC—falling "from $12.375 on November 3, 2003 to $9.75 on November 4, 2003." Petition at 18 n.12. Thereafter it fluctuated—for reasons that petitioners never specify—purportedly rising as high as $16 at some point, and closing at $14 once ninety days had passed. Petition at 18 n.12.

Although petitioners never specify the purportedly relevant "mean trading price" for this period, it apparently was substantially less than *half* the price that each of the named plaintiffs paid for their shares of common stock. That the "look-back" provision could have *any* impact on the damages in this case is doubtful, at best. That it warrants a writ of certiorari is insupportable.

CONCLUSION

This case presents no issues warranting this Court's review. Assuming any conflict among the circuits really exists on proof of loss causation in § 10(b) cases, it makes no difference at all on the facts of this case. Though petitioners endeavor to generate the appearance of a conflict in the law of loss causation, it evaporates on careful inspection of the precedents. Finally, petitioners neither raised their "look-back" argument below, nor explain now how it could have any conceivable impact on the facts of this case. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF

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STATEMENT PURSUANT TO RULE 29.6

Petitioners' corporate disclosure statement was set forth at page *ii* of the Petition for a Writ of Certiorari, and there are no amendments to that statement.

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Whether loss causation can be pleaded and proven in a securities fraud class action absent a causal connection between the alleged fraud and a corresponding decline in share value is solely a question of law, and one which has divided the circuits. Tellingly, respondents' suggestion that no meaningful conflict exits among the circuits is a viewpoint shared by no one else, and is flatly contradicted by the Ninth Circuit in its opinion below.

As all securities litigation practitioners other than respondents acknowledge, the issue of loss causation is the one significant issue defining the scope of claims brought under Section 10(b), which remains to be resolved by this Court. This Court has decided who can be a plaintiff (*Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975)), who can be a defendant (*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)), and the standard for wrongdoing (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)). The Court has also decided whether, in the context of a fraud-on-the-market case, there is an individual reliance requirement (*Basic Inc. v. Levinson*, 485 U.S. 224 (1988)). The proper standard for loss causation, however, has been an open conflict for at least six years now. To delay resolution of this issue will simply postpone the inevitable, and ensure that a significant number of interim decisions by lower courts crowded with securities cases are wrongly decided. Because the issue is as ripe and ready as it will ever be, review at this time is appropriate.

The Ninth Circuit here held "in a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price *on the date of purchase* was inflated because of the misrepresentation. . . . [I]t is not necessary that a disclosure and subsequent drop in the market price of the

stock have actually occurred. . . ." (Pet. App. 9a; emphasis in original) (citations and internal quotations omitted). It is sophistry for respondents to say this case presents only an intra-Ninth Circuit conflict. As the Ninth Circuit held in the decision below: "By contrast, *other* circuits . . . do require demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint." (Pet. App. 9a n.4; emphasis added). Indeed, this conflict has been expressly and judicially acknowledged for over six years.

Similarly, no one other than respondents has suggested that whether the law requires a price drop is dependent on the facts of a given case, nor that there is a different standard for pleading loss causation and proving loss causation. Nor can the meaningful application of the rule to this case be doubted. When it was applied by the district court below, this case was dismissed. Respondents' belated reliance on the November 3, 1998 price decline contradicts their complaint and class allegations and thus provides no basis to avoid the conflict. Notwithstanding respondents' efforts to obfuscate both the existence of the conflict among the circuits and the authorities governing loss causation, the conflict is real, persistent, and well-positioned for resolution by this Court.

I. The Circuit Courts Expressly Acknowledge The Loss Causation Conflict

At least six years ago, the Eleventh Circuit expressly acknowledged the fundamental differences among certain circuits regarding the loss causation requirement. *See Robbins v. Kroger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997):

> some courts have held that '[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.' [citations omitted] . . . Our cases have not utilized the [fraud-on-the-market] theory to alter the loss causation requirement, and we refuse to do so here.

In expressly rejecting interpretations adopted in both the Eighth and Ninth Circuits, the court in *Robbins* held that as a matter of law loss causation could not be established by simply showing that a defendant's misrepresentations resulted in artificially inflated stock prices during the class period. *Id.* at 1448 (citing *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) and *In Re Control Data Corp. Securities Litigation*, 933 F.2d 616, 619-20 (8th Cir. 1991)). Instead, a plaintiff is explicitly required to plead and prove a causal connection between the misrepresentation and the investment's subsequent decline in value. *Id.* at 1448.[1]

Similarly, the holding of the Third Circuit in *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000) confirms the existing conflict. Agreeing with the Eleventh Circuit's decision in *Robbins*, the court explained: "we are persuaded that an investor *must also establish that the alleged misrepresentations proximately caused the decline in the security's value* to satisfy the element of loss causation." *Id.* at 185 (emphasis added). This holding cannot be reconciled with that of the Ninth Circuit, which very clearly

1. Respondents' attempt to establish agreement among the circuits by reference to the "out-of-pocket loss" rule is not only confusing, but misplaced. (Opp. at 7) As the Eleventh Circuit noted in *Robbins*: "Proof of damages under the out-of-pocket rule is not proof of loss causation. Our cases have repeatedly treated loss causation and damages as involving discrete inquiries." *Robbins*, 116 F.3d at 1447 n.5.

prescribes: "it is not necessary that a . . . subsequent drop in the market price of the stock have actually occurred. . . ." (Pet. App. 9a)

The fact that Dura's share price declined somewhat following the Company's November 3, 1998 announcement does not render the Third Circuit's holding consistent with the Ninth Circuit's holding in this case. Unlike the plaintiffs in *Semerenko*, respondents here are not seeking to recover losses in connection with the price decline following the November 3 announcement concerning Albuterol Spiros. This is discussed at length, *infra*, at II. Instead, as both lower courts recognized, respondents are seeking to recover losses associated with an earlier February 25, 1998 price decline, which is not associated with any corrective disclosure regarding Albuterol Spiros. The Ninth Circuit's holding made absolutely no connection between the Albuterol Spiros allegations and the November 3, 1998 price decline. In this respect, the Ninth Circuit's holding is diametrically opposed to that of the Third Circuit in *Semerenko*.[2]

2. Respondents' reliance on the Third Circuit's decision in *EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865 (3d Cir. 2000) is unfounded. Unlike this case, *EP Medsystems* was not a fraud-on-the-market case. Rather, it was an individual investor case and was not based on public misrepresentations or omissions that affected the price of the stock it purchased. As the court there explained "this action is more akin to a contract action than a securities action . . . ." *Id.* at 871. Notably, that court specifically explained that in considering loss causation, it was important to recognize that there were significant distinctions between this case and the usual securities case. *Id.* at 884. As the court stated: "None of the cases in this circuit is analogous. . . . although we take guidance from the language in other cases, . . . the holdings are to some extent inapplicable here." *Id.*

Further judicial acknowledgment of the significance of this conflict was articulated only six weeks ago. *See In re Initial Public Offering Sec. Litig.*, 2003 WL 23096875 *1 (S.D.N.Y. Dec. 31, 2003) (the issue of whether bare allegations of artificial price inflation at the time of purchase are sufficient to plead loss causation under the fraud on the market theory "highlights an important circuit split in the pleading of securities fraud."). In analyzing the conflict, the district court explained: "The Courts of Appeal are deeply divided on this question. The Eighth and Ninth Circuits have recently reaffirmed their holding that allegations of artificial inflation, alone, *are* sufficient.[3] The Third and the Eleventh circuits have held otherwise." *Id.* at *2 (emphasis in original).[4]

In self-serving fashion, respondents now contend that the conflict among the circuits is insignificant — a marked departure from the position respondents articulated before the Ninth Circuit. In arguing below that the district court's ruling on loss causation was wrong, respondents asserted that "Under this [Ninth] Circuit's law . . . [t]he correct focus is on the stock's inflation at the moment of purchase — not on

3. Citing in a footnote to this case, *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, 938 (9th Cir. 2003), and *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

4. The fact that various circuits commonly invoke *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981) in their analysis of loss causation does not negate the existing conflict. *Huddleston* merely sets forth that loss causation is a requirement in Rule 10b-5 cases; unlike the Third, Eleventh and Second Circuits, as well as the Eighth and Ninth, the Fifth Circuit in *Huddleston* did not consider whether bare allegations and proof of price inflation would, without more, be sufficient to satisfy loss causation.

its price at some later time." (Plaintiffs-Appellants Opening Brief at 18). Respondents even criticized the district court's reliance on *Robbins*, arguing that "in this Circuit, *Robbins* does not control." (Plaintiffs-Appellants Opening Brief at 20). Now, however, respondents assert that the price decline following the November 3, 1998 announcement is relevant to the loss causation analysis here. They also assert that *Robbins* is consistent with prior Ninth Circuit precedent. As discussed in further detail below, respondents' changes in position are unavailing.

The conflict among the circuits regarding the rule of loss causation has been recognized by circuit courts, district courts and commentators alike. Indeed, it has even been acknowledged by respondents in their filings below. Respondents' assertion that the differences among the circuits is more a matter of semantics than substantive legal principles is simply wrong.[5] In addition, respondents' suggestion that whether the law requires causation of a stock price decline is something that may vary from case to case is barren of any judicial support. Loss causation is a rule of law that is deserving of uniform and consistent application among the circuits.

5. Respondents' attempt to dismiss as "obiter dictum" the Second Circuit's analysis in *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003) regarding the loss causation standard and its prior holding in *Suez Equity Investors L.P. v. Toronto-Dominion Bank*, 250 F.3d 87 (2d Cir. 2001) is similarly misguided. (Opp. at 11). The court in *Emergent Capital* found that the lower court's reliance on the previous holding in *Suez Equity* was misplaced in that the lower court misinterpreted *Suez Equity*. The Second Circuit's analysis and clarification in this regard amounts to a measured judicial pronouncement regarding the loss causation standard in the Second Circuit and, as such, is not dicta. (*See United States v. Crawley*, 837 F.2d 291, 292-93 (7th Cir. 1988)).

II. Resolution Of The Loss Causation Issue Has A Dispositive Impact In This Case And Is Of Fundamental Importance To Numerous Pending Securities Cases

For the first time, respondents argue that the November 3, 1998 price decline — nine months after the February 24, 1998 termination of the Class Period — is somehow relevant to establishing loss causation in this case. This is a remarkably novel proposition and 180 degree turn by respondents, for nowhere in the operative Second Amended Complaint do they so much as allege the November 3, 1998 price decline. Similarly, respondents did not address the November 3 price decline anywhere in their opposition to defendants' motion to dismiss plaintiffs' Second Amended Complaint. In fact, the only mention respondents make of this price decline is a cursory reference to it in their Opening Brief to the Ninth Circuit. (Plaintiffs-Appellants' Opening Brief at 21). Even then, respondents did not argue that it was a loss for which they ought to recover, nor did they assert it as a basis for establishing loss causation.

Respondents' sudden shift in position does not comport with the action they filed, and, in any event, should not be tolerated. As this Court recently reiterated, where "a party assumes a certain position in a legal proceeding, and succeeds in maintaining that position, he may not thereafter, simply because his interests have changed, assume a contrary position." *New Hampshire v. Maine*, 532 U.S. 742, 749 (2001), *quoting Davis v. Wakelee*, 156 U.S. 680, 689 (1895). This rule serves the "integrity of the judicial process" by preventing parties from "playing fast and loose with the courts" based on the "exigencies of the moment." *Id.* (citations and internal quotations omitted).

The fact is, the November 3, 1998 price decline is irrelevant to respondents' claims. As required by the Reform Act, a plaintiff who brings a securities fraud claim "shall have the burden of proving that the act or omission of the defendant alleged to violate [the Exchange Act] *caused the loss for which the plaintiff seeks to recover damages*." 15 U.S.C. § 78u-4(b)(4) (emphasis added) (reproduced at Pet. App. 54a). As the cases discussed herein make clear, this requirement applies equally at both the pleading and proof stages. Respondents' Class Period ends on February 24, 1998. The "loss" for which respondents seek to recover here is that associated with the 47% price decline that occurred between February 24, 1998 and February 25, 1998. The abbreviated November 3, 1998 price decline — ninth months later — is not part of this equation. Respondents have not claimed — nor do they claim here — that they are seeking to recover for any loss that occurred on November 3, 1998.[6]

Accordingly, this Court's resolution of the question presented will be dispositive of respondents' Albuterol Spiros claims in this case. The proper standard for loss causation is a question of law, which can be (and indeed should be) addressed at the Rule 12(b)(6) stage. Should this Court reject the standard applied by the Ninth Circuit and adopt an interpretation similar to that applied in the Eleventh, Third and now Second Circuits, respondents' claims regarding Albuterol Spiros will be dismissed, just as the district court did below.

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6. Respondents presumably did not seek to recover losses associated with the November 3, 1998 price decline because within twelve trading days, the stock price had recovered, and within ninety days it closed $1.625 higher than it was prior to the November 3 announcement. Not surprisingly, respondents strategically elected to end their Class Period on February 24, 1998, with the 47% price decline, and not nine months later, with the temporary 21% price decline, where the shares immediately rebounded. (Petition at 15-19).

Resolution of the question presented will also have an impact far beyond this case. There are currently hundreds of securities cases making their way through the federal court pipeline that are affected by the loss causation conflict. *See* Motion For Leave To File A Brief As *Amicus Curiae* and Brief for the Securities Industry Association as *Amicus Curiae* in Support of Petitioners at 5. A uniform rule on loss causation is, therefore, important to prevent even more cases from being wrongly decided.

III. Petitioners Did Not Raise The Reform Act's "Look Back" Provision As A New Issue

Petitioners did not raise the Reform Act's "look back" provision as a new issue, nor do petitioners suggest that this provision will resolve the existing conflict regarding loss causation. Rather, petitioners raise the "look back" provision as a tangible illustration of how the Ninth Circuit's rule does not comport with the overall statutory scheme of the Reform Act. As exemplified by the "look back" provision, its measure of damages or "loss" is applied at the conclusion of the class period and in connection with a contemporaneous stock price decline, and is not measured by the stock's behavior at some unspecified later time which is bereft of any nexus to the class period.

CONCLUSION

This Court should grant the petition for certiorari.

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Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

~~MOTION FOR LEAVE TO FILE~~ SUPPLEMENTAL BRIEF IN RESPONSE TO SOLICITOR GENERAL'S BRIEF FOR THE UNITED STATES AS *AMICUS CURIAE*; SUPPLEMENTAL BRIEF

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Respondents respectfully request leave to file the following supplemental brief in response to the Solicitor General's amicus curiae brief, which—respondents respectfully submit—misstates Ninth Circuit law and overstates the significance of the Question Presented on the record in this case.

Respectfully submitted,

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QUESTION PRESENTED

Whether a securities-fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price.

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SUPPLEMENTAL BRIEF IN RESPONSE TO SOLICITOR GENERAL'S BRIEF

The Solicitor General perceives conflict among the circuits because he misunderstands—and misstates—Ninth Circuit law. This can be seen in the Solicitor General's assertions, for example, that following the Ninth Circuit's approach to loss causation means double-recovery windfalls for in-and-out traders. SG Brief at 11. The Solicitor General's assertions are flatly contradicted by controlling Ninth Circuit precedent, under which the investor who buys at an artificially inflated price, then sells at an inflated price, is deemed to recoup some or all of his loss and is denied a double recovery. "If the stock is resold at an inflated price,"

the Ninth Circuit holds, "the purchaser-seller's damages . . . must be diminished by the inflation he recovers from his purchaser." *Blackie v. Barrack*, 524 F.2d 891, 908-09 (9th Cir. 1975); *accord, e.g., Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437-38 & n.4 (9th Cir. 1987); *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345-46 (9th Cir. 1976) (Sneed, J., concurring).

"For purchasers who sell *after* a disclosure which completely corrected the misrepresentations of the defendant, damages are determined only at the *time of purchase*." *Wool*, 818 F.2d at 1437 n.4 (court's emphasis). "For in-and-out traders, on the other hand, both the *time of purchase* and the *time of sale* are considered in determining recoverable damages." *Id.* (court's emphasis). The Ninth Circuit explained in *Wool*:

> Instead of determining the damages at the date of purchase, therefore, a two-step process is used when dealing with in-and-out traders. First, the spread between market price and value of the stock at the time of purchase is determined. When the purchaser sells the stock, the spread is again measured.

Id. "If the spread has diminished" the purchaser would recover the difference. *Id.* But not otherwise. The Ninth Circuit thus follows the very approach advocated by the Solicitor General—focusing on the relative level of inflation in a security's price, at both the time of purchase and of any subsequent sale.

While the Solicitor General suggests the Third Circuit's opinion in *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000), adopted a radically different position from the Ninth Circuit's, in truth the Third Circuit embraced and followed the Ninth Circuit approach articulated in Judge Sneed's *Occidental Petroleum* concurrence and applied in *Blackie* and *Wool*:

> In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price. *See Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345 (9th Cir. 1976) (Sneed, J., concurring) (stating that an investor's proximate losses are limited to those amounts that are attributable to the unrecovered inflation in the purchase price).

Semerenko, 223 F.3d at 185.

This is the law applied by district courts in the Ninth Circuit.[1] And it is by no means an innovation of the Ninth Circuit. *See, e.g., In re LTV Sec. Litig.*, 88 F.R.D. 134, 148-49 (N.D. Tex. 1980) (cited with approval in *Basic Inc. v. Levinson*, 485 U.S. 224, 246 n.24 (1988)). There is no risk of double recovery in the Ninth Circuit—or anywhere else, for that matter.

After misstating Ninth Circuit law to produce imagined conflicts, the Solicitor General acknowledges that the real issue should not, in any event, be stated in terms of a "decline in price" as the Petition for Certiorari has it. *See* SG Brief at 12-13. "As formulated by petitioners, and by the courts in the cases on which petitioners rely," the Solicitor General writes, "the loss-causation standard requires a decline in the stock's price." SG Brief at 12. "That formulation may simply reflect the fact that, as in most securities fraud cases, there was in fact a decline in price in this case and the others that petitioners cite." SG Brief at 12-13. Indeed, as the respondents' Opposition to the Petition for Certiorari pointed out—the precedents are fact bound, their holdings fact specific.

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[1] *See, e.g., In re California Micro Devices Sec. Litig.*, 168 F.R.D. 257, 263 (N.D. Cal. 1996) (applying Ninth Circuit law, "both the time of purchase and the time of sale are considered"); *In re Cirrus Logic Sec. Litig.*, 155 F.R.D. 654, 661 (N.D. Cal. 1994) ("an in/out plaintiff recoups at least some of the loss incurred by the purchase because he both buys and sells during the period of price inflation"); *Hoexter v. Simmons*, 140 F.R.D. 416, 421 (D. Ariz. 1991) (following *Wool*).

The Solicitor General aptly states that the precedents therefore need not and ought not be interpreted to require such a price decline in every case: "A decline in price may not be a necessary condition for loss causation, however, because the inflation attributable to fraud could be reduced or eliminated even if there were a net increase in price." SG Brief at 13. "Thus, while it is ordinarily a decline in the price of stock that harms investors, they can also be harmed '[i]f a stock does not appreciate as it would have absent the fraudulent conduct,' so that their profit is smaller than it would otherwise have been." SG Brief at 13 (quoting *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831-32 (8th Cir. 2003)).

The Solicitor General elaborates: "As Judge Easterbrook has observed, 'a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counterbalancing the loss.'" SG Brief at 13 (citing *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 966 (7th Cir. 1989)). That, of course, is the Ninth Circuit's position as well—that while a decline in price is one way of showing artificial inflation and loss, in our factually complex world it cannot be the only one.[2] This conclusion is entirely

[2] *See, e.g., Blackie v. Barrack*, 524 F.2d 891, 909 n.25 (9th Cir. 1975). In *Blackie*, when defendants argued "that the inflation paid must be measured by the change in price after a corrective release," the Ninth Circuit observed that such a "drop is of course circumstantial evidence of the inflation when purchased, but it is not the exclusive method of measuring inflation." *Id.* at 909 n.25. For in many cases "the drop after a corrective disclosure will not be conclusive of the amount of original inflation, both because the correction may be only partial (as is alleged of the major corrections involved here), and because the prolonged nature of the fraud introduces other market variables which may affect the amount the market reacted to disclosures at different times during the class period." *Id.* The Ninth Circuit's position turns out to be the same as the Solicitor General's—and the other Circuits. *Compare Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (Wallace, J.), *with Goldberg*, 890 F.2d at 966 (Easterbrook, J.).

consistent with Judge Posner's opinion in *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 682-83 (7th Cir. 1990), that an investor cannot point to a decline in price entirely unrelated to fraud and claim it as the measure of artificial inflation and loss.[3] The Ninth Circuit precedents similarly hold that those who point to a decline to prove loss must connect it to the fraud they allege.[4]

The Circuits and the Solicitor General thus agree in substance—that a decline in price is not necessarily required to show loss causation. They agree as well that a decline can be *relevant* to showing loss, however, and that plaintiffs who *do* rely on a decline in price to show loss eventually must connect it to the fraud alleged. The "conflict" in some language of the precedents turns out to be a fact-bound semantic dissonance.

Petitioners' Question Presented is not really presented in this case in any event. The Solicitor General says the case is ripe for review because the undisputed fact that Dura stock dropped over 20% when the FDA denied approval is not clearly pleaded. SG Brief at 17. It is, however, part of the record—based on the petitioners' own request for judicial notice. *See* ER79Ex.L. That request for judicial notice of Dura stock prices was both unopposed and wholly proper.[5] Petitioners placed the stock prices before the Ninth Circuit as well. *See* SER79Ex.L. And their Petition for Certiorari itself

[3] *See, e.g., Gray v. First Winthrop Corp.*, 82 F.3d 877, 886 (9th Cir. 1996) (discussing and distinguishing *Bastian*).

[4] *See, e.g., Heliotrope General, Inc. v. Ford Motor Co.*, 189 F.3d 971, 978 & n.12 (9th Cir. 1999); *Ambassador Hotel Co. v. Wei Chan Investment*, 189 F.3d 1017, 1027 (9th Cir. 1999); *Binder v. Gillespie*, 184 F.3d 1059, 1065-66 (9th Cir. 1999); *Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir. 1996); *McGonigle v. Combs*, 968 F.2d 810, 820-21 (9th Cir. 1992).

[5] *See, e.g., La Grasta v. First Union Secs., Inc.*, 358 F.3d 840, 842 (11th Cir. 2004); *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 167 n.8 (2d Cir. 2000).

concedes: "Dura's share price declined somewhat following the November 3 announcement, from $12.375 to $9.75." Petition at 3 n.4. That is a deflationary drop—connected to the alleged fraud—of over 20%.

The record reveals that this 20% drop was on a partial disclosure, not a full disclosure of the facts, and that the stock would have dropped even further had Dura's press release not downplayed the significance of the FDA action that it presented as merely a temporary setback. *See* ER72 (Complaint ¶ 136). The FDA responded to the press release with a "notice of violation" warning petitioners that "[t]he Division of Drug Marketing, Advertising and Communications (DDMAC) . . . found that Dura's press release sent a message that 'misleadingly minimizes the fact that Dura must perform a completely new clinical [study]. . . .'" ER72 (Complaint ¶ 136, quoting FDA notice). Since the Ninth Circuit directed that leave to amend be given on remand, respondents soon will be filing an amended complaint demonstrating how the remaining inflation was removed from Dura's stock price over the following months, until Dura finally admitted that it had abandoned its Albuterol Spiros drug-delivery product as hopeless. That, of course, will moot whatever questions this Court might grant certiorari to resolve.

Such factual complications also underscore how inadvisable it would be—in any event—for this Court to adopt rules resolving intensely factual loss-causation issues as a matter of law *at the pleading stage*. The Solicitor General concedes that the price of a security need not necessarily decline for investors to have claims—and that the real analysis is of inflationary impact on market price as it fluctuates over time. SG Brief at 12-13. That presents questions of fact—and potentially messy ones, at that. *See Basic Inc. v. Levinson*, 485 U.S. 224, 248-49 & n.29 (1988); *Gebhardt*, 335 F.3d at 832; *Blackie*, 524 F.2d at 909 n.25. Determining when and how information affected stock price

is by no means a task so simple that it may be decided on the pleadings—surely not by simplistically pairing specific price movements and disclosures. Economists warn that stock prices may reflect new information before it is formally announced.[6] That is no secret to this Court, which in *Dirks v. SEC*, 463 U.S. 646, 649-50 (1983), noted that surreptitious stock sales by investors with access to adverse inside information regarding a company's accounting improprieties drove its stock from $26 per share to less than $15 per share in two weeks—causing the New York Stock Exchange to halt trading—before any public disclosure of the accounting fraud.[7] In other cases the market's reaction to a corporation's announcements may be delayed, as it takes time for an opaque disclosure's real significance to sink in. For as this Court has noted, "not every mixture with the true will

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[6] *See, e.g.*, Burton G. Malkiel, *A Random Walk Down Wall Street* 192 (8th ed. 2003) ("Research indicates that, on average, stock prices react well in advance of unexpectedly good or unexpectedly bad earnings reports."); William F. Sharpe & Gordon J. Alexander, *Investments* 522 (4th ed. 1990) (Nobel laureate summarizes research showing that "prices of firms that announced unexpectedly low earnings ... tended to decrease prior to the announcement"); James H. Lorie, Peter Dodd & Mary Hamilton Kimpton, *The Stock Market: Theories and Evidence* 100-02 (2d ed. 1985) (citing research indicating that price adjustments begin in advance of formal earnings announcements); Sara Fisher Ellison & Wallace P. Mullin, *Gradual Incorporation of Information Into Stock Prices: Empirical Strategies*, National Bureau of Economic Research Working Paper No. 6218, at 4, 13-17 (Oct. 1997) (price effects seen weeks in advance of merger announcements); Ray Ball & Phillip Brown, *An Empirical Evaluation of Accounting Income Numbers*, 6 J. Acctg. Res. 159, 160-70 & Fig. 1 (1968) (earnings reports).

[7] *Dirks*, 463 U.S. at 649-50; *see also Dirks v. SEC*, 681 F.2d 824, 831-32 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983). In *SEC v. Shapiro*, 494 F.2d 1301, 1307 n.3 (2d Cir. 1974), the Second Circuit similarly noted that trading by insiders who knew of *undisclosed* favorable information "pushed the price of [the] stock by February 18 to nearly three-and-one-half times what it had been at the beginning of the year."

neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so . . . ." *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1097 (1991).

When and how information entered the market and affected stock prices is a matter for detailed evidence and careful analysis by expert witnesses and triers of fact—not for decisions on the pleadings. *See Basic*, 485 U.S. at 249 n.29 ("[p]roof of that sort is a matter for trial"); *Gebhardt*, 335 F.3d at 832. The point is underscored, to say the least, by the far greater complexity of other securities cases currently in the news—in which defendants hope to escape liability by demanding that "loss causation" be decided on the pleadings.[8]

The Petition for a Writ of Certiorari should be denied.

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[8] *See, e.g.*, *Fogarazzo v. Lehman Brothers, Inc.*, No. 03 Civ. 5194, 2004 U.S. Dist. LEXIS 9193, at *28-*50 (S.D.N.Y. May 21, 2004); *In re AOL Time Warner, Inc. Sec. & "ERISA" Litig.*, MDL No. 1500, No. 02 Civ. 5575 (SWK), 2004 U.S. Dist. LEXIS 7917, at *96-*97 & n.39 (S.D.N.Y. May 5, 2004); *In re Enron Corp. Sec. Litig.*, No. MDL-1446, Civ. No. H-01-3624, 2004 U.S. Dist. LEXIS 8157, at *17-*23, *34-*36 (S.D. Tex. Mar. 29, 2004); *In re WorldCom, Inc. Sec. Litig.*, 294 F.Supp.2d 392, 428-29 (S.D.N.Y. 2003).

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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

SUPPLEMENTAL BRIEF FOR PETITIONERS

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STATEMENT PURSUANT TO RULE 29.6

Petitioners' corporate disclosure statement was set forth at page *i* of their reply brief, and there are no amendments to that statement.

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Petitioners do not oppose respondents' motion for leave to file a supplemental brief in response to the Solicitor General's Brief for the United States as *Amicus Curiae* so long as this Response is considered also.

1. This case is about the proper standard for pleading loss causation. Whether reversal by the Supreme Court results in a complete dismissal of respondents' Albuterol Spiros claims or the filing of an amended (albeit severely limited) complaint by respondents, there can be no doubt that the determination of the proper standard for loss causation "is fundamental to the further conduct of the case" and therefore meets the standard for review. *United States v. General Motors Corp.*, 323 U.S. 373, 377 (1945) (granting certiorari to determine which items of loss would properly be part of damages). As the Solicitor General demonstrated, that standard is easily met here. (SG Brief at 15-18).

If the Court reverses, one of two outcomes will happen. The most likely is that the district court's dismissal will be affirmed. The only other possible outcome is that the respondents will be required to replead to limit their Albuterol Spiros claims to the decline after the November 1998 announcement. This will both eliminate all claims for class members that sold before the November 1998 announcement, and drastically reduce or negate any alleged damages for all remaining class members. (*See* Pet. at 18; Pet. Reply at 8). Thus, the Court's ruling will be "fundamental to the further conduct of the case" on remand whichever course is followed. Accordingly, certiorari should be granted to resolve the important and recurring circuit conflict on loss causation.[1]

1. Supreme Court precedent is replete with examples of cases where the Court has accepted review of and decided issues concerning (Cont'd)

2. Respondents' Supplemental Brief recycles the arguments previously expressed by them in their Response in Opposition to Petition for Writ of Certiorari. Again, respondents fail in their attempt to obfuscate the existence of the acknowledged conflict among the circuits – a viewpoint that is shared by no one else. The conflict was expressly recognized by the Ninth Circuit in its decision below as well as by other courts, by petitioners, and by the Securities Industry Association. It is also now acknowledged in this case by the Solicitor General and the Securities and Exchange Commission. That conflict has been thoroughly briefed by petitioners, the Securities Industry Association as Amicus Curiae, and the United States as Amicus Curiae. Those arguments need not be reiterated here. As each of the briefs submitted by these parties illustrates, and as the Ninth Circuit itself has expressly

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(Cont'd)
the appropriate scope or measure of relief available to a plaintiff, and such review was not impeded where applying the correct legal standard would not result in dismissal of the action in its entirety. *See, e.g., Norfolk & Western Ry. Co. v. Ayers*, 538 U.S. 135 (2003) (addressed issue of whether asbestosis plaintiff could recover pain and suffering damages for his fear of developing cancer; availability of other relief was not in question); *United States v. Bornstein*, 423 U.S. 303 (1976) (in a False Claims Act case, the issue was how many forfeitures the government was entitled to and how double damages were to be calculated; there was no dispute as to the government's entitlement to the forfeitures and to double damages). Also, as noted in our prior submission, the Court has granted certiorari to resolve important Rule 10b-5 issues in other cases involving circuit court reversals of Rule 12(b)(6) dismissal of complaints. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 469 (1977) (establishing that Rule 10b-5 does not cover mismanagement or breach of fiduciary duty); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727 (1975) (establishing that private Rule 10b-5 plaintiff must be a purchaser or seller).

acknowledged, the conflict is real, persistent and well-positioned for resolution by this Court.[2]

3. Notwithstanding respondents' assertion that the Solicitor General has misunderstood and misstated Ninth Circuit law, respondents nonetheless argue that the Solicitor General is, in fact, aligned with their position that a decline in stock price is not necessary to establish loss causation. This interpretation of the Solicitor General's position is not reasonable. The Solicitor General clearly indicates that in order to establish loss causation, there must be an actual reductive effect in the price of the stock – whether in the form of an overall decline in stock price or a decline in price which is masked by an unrelated increase – that results from disclosure of the alleged misrepresentation. As the Solicitor General reasoned,

> it cannot be said that an investor in a fraud-on-the-market case who purchases a security at an inflated price has suffered *any* loss at the time of purchase, much less one caused by the defendant's misrepresentation. . . . Measuring the loss in such a case as of the time of purchase, and not requiring

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2. As the Solicitor General correctly pointed out, in their petition for rehearing en banc, petitioners invited the Ninth Circuit to reconsider its decision, in light of the inter-circuit conflict as well as the intra-circuit conflict. (Pet. App. 52a-53a). The Ninth Circuit denied the petition without comment. As such, the decision here is the law of the Ninth Circuit on loss causation. Indeed, it already has been cited as such by district courts. *See In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, 310 F. Supp.2d 819, 836 (S.D. Tex. Mar. 29, 2004); *In re Electronic Data Systems Corp. Securities and "ERISA" Litigation*, 298 F. Supp.2d 544, 560 (E.D. Tex. Jan. 13, 2004).

> any allegation of a *subsequent* loss of value attributable to the fraud, would grant a windfall to investors. . . .

(SG Brief at 11) (emphasis added).

In their attempt to align the Solicitor General's position with their own, respondents rely solely on the Solicitor General's hypothetical example wherein the disclosure of negative and positive information results in an overall net increase in stock price and thus a masking of the reduction in price caused by the negative disclosure. (SG Brief at 13). This hypothetical is of no matter to this case because here we do not have even an allegation of a post-disclosure price reduction masked by other positive information. Instead, respondents seek to recover losses for the February 25, 1998 decline in stock price, which, by their own admission, is not causally related to the much later disclosure of the alleged misrepresentations concerning Albuterol Spiros. Moreover, the Solicitor General's hypothetical still requires an allegation and proof that disclosure of the correct information is what reduced the price of the stock from what it "would otherwise have been." (SG Brief at 13). The Solicitor General clearly stated its position that the Ninth Circuit's decision here was incorrect and erroneous. Respondents' efforts to mischaracterize the position of the Solicitor General should be disregarded. Which party will benefit by the legal rule proposed by the Solicitor General is of no current import. The sole question here is whether this Court should grant certiorari, which the Solicitor General has urged it to do.

4. Respondents appear to posit that upon amending their complaint, they can assert claims based on the November 3, 1998 Albuterol Spiros announcement by Dura and subsequent

share price decline on behalf of the putative class. In fact, respondents cannot now attempt to expand their class to include purchasers of Dura stock beyond February 25, 1998 through the November 3, 1998 announcement. Such an expansion would be time-barred. *See In re Syntex Corp. Sec. Litig.*, 95 F.3d 922, 935-36 (9th Cir. 1996) (extension of class period denied where time-barred and would not relate back because two groups would not have identity of interests and claimants bought stock at different values and after different disclosures and statements were made by defendants); *In re Commtouch Software Ltd. Sec. Litig.*, 2002 WL 3147998 (N.D. Cal. July 24, 2002) (following *Syntex* and rejecting attempt to expand class period where statute of limitations had lapsed). Consequently, respondents are in fact limited to attempting to fashion allegations on behalf of the previously defined putative class. Further, the leave to amend afforded respondents by the Ninth Circuit's Order on the issue of scienter does not empower them to assert claims concerning the November 3, 1998 announcement on behalf of even this class, *nor did respondents ever seek such relief.* (Pet. App. 15a-16a). Nowhere did the Ninth Circuit afford leave to amend with respect to the November 1998 share price decline or any other novel or previously unraised causation theories.

Moreover, petitioners are unaware of any authority supporting respondents' novel construction of a securities class action with an identified class period asserting a damages claim associated with a share price decline which occurred nine months after the conclusion of that class period. Such a construct is inconsistent with the basic principles courts consistently apply in securities class actions where it is the behavior of the share price or investment during or immediately at the end of the class period that is relevant to

demonstrate economic loss. *See, e.g., Robbins v. Kroger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997) ("Plaintiffs offered no evidence of a connection between Deloitte's misrepresentation and the decline in price of KPI stock throughout the class period or following the October 1990 dividend cut [at the end of the class period]."); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185-86 (3d Cir. 2000) (holding that plaintiffs' actual economic loss had been sufficiently alleged where share price decline occurred at conclusion of class period).

Respondents' counsel are among the most sophisticated practitioners in this field among the plaintiffs' bar. They were aware of all of the Albuterol Spiros developments, the November 3, 1998 announcement and movements in Dura's share price up until February 1999 when they filed their first complaint. It is not accidental that they consciously elected to define their Class Period as ending on February 25, 1998 with its more substantial associated price decline. They had the opportunity to amend this Class Period and these very allegations as late as September 23, 2000, prior to the district court's dismissal of the action, and elected not to do so.

5. Respondents argue that because establishing loss causation can be factually complicated and "potentially messy," it is not something to be resolved as a matter of law at the pleading stage. (Resp. Supp. Brief at 6). As the cases discussed in the Petition and the supporting briefs make clear, the required element of loss causation is a rule of law that applies equally at both the pleading and proof stages – a proposition which respondents do not dispute. But this argument is inapplicable to this case. Respondents never alleged (in either simple or complicated fashion) any decline in share price (actual or masked) from the information about Albuterol Spiros announced on November 3, 1998.

This case presents the loss causation issue plainly and cleanly. The decline in value for which respondents seek to recover occurred on February 25, 1998, the day after the class period ended, when the price of Dura's stock dropped 47%. Respondents do not allege, however, that the 47% drop was caused by Dura's announcement regarding Albuterol Spiros, because it was not until nine months later in November 1998 that Dura and the public learned that the FDA did not approve Albuterol Spiros. The facts of this case are neither complex nor messy. Indeed, when the district court applied the proper standard for loss causation, it granted petitioner's Rule 12(b)(6) motion and dismissed respondents' complaint and its Albuterol Spiros-based allegations with prejudice.

This Court should grant the petition for *certiorari*.

Respectfully submitted,

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No. 03-932

In the Supreme Court of the United States

DURA PHARMACEUTICALS, INC., ET AL., PETITIONERS

v.

MICHAEL BROUDO, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price.

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In the Supreme Court of the United States

No. 03-932

DURA PHARMACEUTICALS, INC., ET AL., PETITIONERS

v.

MICHAEL BROUDO, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is submitted in response to the order of this Court inviting the Solicitor General to express the views of the United States. Because the court of appeals decided an important question of federal securities law incorrectly and in a manner that conflicts with decisions of other courts of appeals, and because this case is a suitable vehicle for resolving the conflict, the position of the United States is that the petition for a writ of certiorari should be granted.

STATEMENT

1. a. Petitioner Dura Pharmaceuticals, Inc. (Dura) developed and marketed products for the treatment of allergies, asthma, and other respiratory conditions. Pet. App. 2a n.1. In 1995, it began developing a delivery device for asthma drugs called Albuterol Spiros. *Id.* at 19a-20a. The following year, it began selling a respiratory antibiotic called Ceclor CD. *Id.* at 41a. In an April 15, 1997, press release

announcing better-than-expected results for the first quarter of 1997, Dura stated that "strong progress" had been made in selling Ceclor CD, and that "[p]atient dosing" had been completed for the Albuterol Spiros clinical trials that were necessary before a new drug application (NDA) could be submitted to the Food and Drug Administration (FDA). *Id.* at 3a. Dura filed the NDA for Albuterol Spiros in November 1997. *Id.* at 4a.

On February 24, 1998, Dura announced that, for a number of reasons, including slower than expected sales of Ceclor CD, it was anticipating lower revenues and earnings per share in 1998 than had previously been forecast. The next day, the price of Dura stock dropped to $20 3/4 from $39 1/8, a 47% one-day loss. The February 24 announcement did not mention Albuterol Spiros. Pet. App. 5a, 7a, 40a.

Dura's business declined throughout the remainder of 1998. Pet. App. 5a. In November 1998, Dura announced that the FDA had decided not to approve Albuterol Spiros, "due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns." *Ibid.* Although the complaint in this case does not allege any decline in Dura's stock price after the November 1998 disclosure, it is a fact that, following the announcement, the price of Dura stock dropped from $12 3/8 to $9 3/4. Pet. 3 n.4; Pet. C.A. Supp. E.R. Tab 79, Exh. L. Within twelve trading days, however, the stock was again selling at nearly $12 1/2. *Ibid.*

b. Respondents, shareholders who purchased Dura stock between April 15, 1997, and February 24, 1998, filed several securities-fraud class actions against Dura and a number of its senior officers and/or directors, who are also petitioners here. After the complaints were consolidated and amended, the district court dismissed the resulting complaint without prejudice. Respondents then filed a second consolidated amended complaint (complaint). The complaint alleged that petitioners made false and misleading statements about

Dura's performance during the class period, and thereby violated Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, as well as Section 20(a) of the Exchange Act, 15 U.S.C. 78t(a), the "controlling person" provision. Pet. App. 2a, 5a-6a, 18a-19a.

According to the complaint, petitioners made misrepresentations concerning a number of different aspects of Dura's business, only two of which are still at issue: sales of Ceclor CD and the development of Albuterol Spiros. Respondents alleged that petitioners deliberately misled the investing public into believing that Ceclor CD was selling better than it in fact was and that the prospects for Albuterol Spiros were better than they in fact were. Pet. App. 2a-3a, 6a-7a, 12a, 27a, 34a-39a, 41a-44a.

2. The district court granted petitioners' motion to dismiss. Pet. App. 18a-51a. It held that the allegations concerning Ceclor CD did not satisfy the pleading requirements for securities-fraud claims, because they did not adequately demonstrate that the challenged statements were made with scienter. *Id.* at 45a-47a. It held that the allegations concerning Albuterol Spiros failed to state a claim under Rule 10b-5, because they did not satisfy the element of loss causation, which means that "the misrepresentations or omissions caused the harm." *Id.* at 39a-40a (quoting *Binder* v. *Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999), cert. denied, 528 U.S. 1154 (2000)). And it ordered that the dismissal be with prejudice, because respondents had already had an opportunity to amend the complaint to satisfy the applicable pleading requirements. *Id.* at 51a.

In holding that the Albuterol Spiros allegations did not satisfy the element of loss causation, the district court relied on the facts that Dura's announcement on February 24, 1998, did not "contain[] any negative information about Albuterol Spiros"; that "Dura did not announce that the FDA would

not approve Albuterol Spiros until nine months later, in November 1998"; and that the complaint therefore "does not contain any allegations that the FDA's non-approval had any relationship to the February price drop." Pet. App. 40a. Rather than having a connection with "the alleged misrepresentations and omissions regarding Albuterol Spiros," the district court said, "the decline in Dura's stock price" on February 24 "was the result of an expected revenue shortfall." *Ibid.*

3. The court of appeals reversed and remanded for further proceedings. Pet. App. 1a-17a. With respect to the Ceclor CD allegations, the court of appeals held that, although the district court correctly concluded that each allegation of scienter was insufficient standing alone, it failed to determine whether the allegations were sufficient when considered collectively. Pet. App. 11a-14a. The court also held that, contrary to the conclusion of the district court, the Albuterol Spiros allegations did satisfy the element of loss causation. *Id.* at 8a-11a. And the court held that respondents should have been granted leave to amend their complaint. *Id.* at 15a-16a & n.6. The court declined petitioners' invitation to affirm on alternative grounds not addressed by the district court. *Id.* at 16a.

In holding that respondents had adequately alleged loss causation, the court of appeals noted that that element is satisfied if the plaintiff shows that "the misrepresentation touches upon the reasons for the investment's decline in value." Pet. App. 8a (quoting *Binder*, 184 F.3d at 1066). While acknowledging the ambiguity of the phrase "touches upon," the court followed prior decisions of the Ninth Circuit holding that a plaintiff in a fraud-on-the-market case[1]

[1] Under the fraud-on-the-market theory, an investor's reliance on a "public material misrepresentation[]" is presumed, because "most publicly available information is reflected in market price." *Basic Inc.* v. *Levinson*, 485 U.S. 224, 247 (1988).

establishes loss causation if he shows that "the price on the date of purchase was inflated because of the misrepresentation." *Id.* at 9a (quoting *Knapp* v. *Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996), cert. denied, 519 U.S. 1112 (1997)). "[I]t is not necessary," the court said, "that a disclosure and subsequent drop in the market price of the stock have actually occurred," because "the injury occurs at the time of the transaction," which is the time at which "damages are to be measured." *Ibid.* The court thus held that, to satisfy the element of loss causation, a plaintiff need not plead "a stock price drop following a corrective disclosure or otherwise"; he need only plead "that the price at the time of purchase was overstated and sufficient identification of the cause." *Ibid.* The court concluded that the complaint satisfied this requirement, because it alleged that "the price of the stock was overvalued in part due to the misrepresentations * * * that the development and testing of the Albuterol Spiros device were proceeding satisfactorily and that FDA approval of the device was imminent." *Id.* at 10a-11a.

The court acknowledged that the Third and Eleventh Circuits apply a different standard of loss causation. Those circuits, the court said, "do require demonstration of a corrective disclosure followed by a stock price drop." Pet. App. 9a-10a n.4 (citing *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000), cert. denied, 531 U.S. 1149 (2001), and *Robbins* v. *Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997)).

DISCUSSION

The petition for a writ of certiorari should be granted. There is an acknowledged circuit conflict regarding the

nature and scope of the plaintiff's burden to plead and prove loss causation in a fraud-on-the-market case under Rule 10b-5; the court of appeals decided that question incorrectly; the question is one of recurring importance; and this case is a suitable vehicle for resolving it.

A. The Court Of Appeals' Decision Conflicts With Decisions Of Other Courts Of Appeals

1. Quoting its decision in *Knapp* v. *Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996), cert. denied, 519 U.S. 1112 (1997), the court of appeals held that, "[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." Pet. App. 9a. The court also held that "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred." *Ibid.* Acknowledging that its decision conflicts with decisions of the Third and Eleventh Circuits, however, the court stated that those courts "do require demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint." *Id.* at 9a-10a n.4.

The Eleventh Circuit case cited by the court of appeals, *Robbins* v. *Koger Props., Inc.*, 116 F.3d 1441 (1997), held that "proof that a plaintiff purchased securities at an artificially inflated price, without more," does not "satisf[y] the loss causation requirement," and it explicitly rejected the Ninth Circuit's contrary decision in *Knapp*. *Id.* at 1448. The Eleventh Circuit instead concluded that there must be "proof of a causal connection between the misrepresentation and the investment's subsequent decline in value." *Ibid.* Applying that principle, it reversed a jury verdict for the plaintiffs, because, while there may have been sufficient evidence that the defendant's misrepresentations artificially inflated the price of the stock, there was no evidence of any

connection between the misrepresentations and a decline in the stock's price. *Ibid.*

The Third Circuit case cited by the court below, *Semerenko* v. *Cendant Corp.*, 223 F.3d 165 (2000), cert. denied, 531 U.S. 1149 (2001), followed the Eleventh Circuit's decision in *Robbins*. *Id.* at 185. Applying the principle that loss causation requires "the value of the security * * * [to] actually decline as a result of an alleged misrepresentation," the Third Circuit reversed the dismissal of a complaint because the plaintiffs alleged that they had purchased stock "at a price that was inflated due to the alleged misrepresentations" and had "suffered a loss when the truth was made known and the price of [the] stock returned to its true value." *Ibid.*

2. The court of appeals' decision is also inconsistent with decisions of the Second and Seventh Circuits. As support for its holding that loss causation requires only that the misrepresentations inflated the purchase price, the Ninth Circuit cited (Pet. App. 9a) the Second Circuit's decision in *Suez Equity Investors, L.P.* v. *Toronto-Dominion Bank*, 250 F.3d 87 (2001). But in a case decided about a month after the decision in this case, the Second Circuit made clear that it rejects the Ninth Circuit's standard. Clarifying its decision in *Suez Equity Investors*, the Second Circuit held in *Emergent Capital Investment Management, LLC* v. *Stonepath Group, Inc.*, 343 F.3d 189 (2003), that a mere allegation that fraudulent omissions "'induced a disparity between the price plaintiff paid for the * * * shares and their true investment quality'" at the time of purchase "cannot satisfy the loss causation pleading requirement." *Id.* at 198. Instead, the court said, loss causation "require[s] that securities fraud plaintiffs demonstrate a causal connection between the content of the alleged misstatements or omissions and 'the harm actually suffered.'" *Id.* at 199 (quoting *Suez Equity*, 250 F.3d at 96). The court concluded that that standard was

satisfied in the case before it, because the complaint adequately alleged a causal connection between the omissions and "the decline in [the] stock value." *Id.* at 197.

Insofar as it rejects the view that loss causation requires a connection between the fraud and a decline in the investment's value, the Ninth Circuit's decision is also inconsistent with the Seventh Circuit's decision in *Bastian* v. *Petren Resources Corp.*, 892 F.2d 680 (Posner, J.), cert. denied, 496 U.S. 906 (1990). That case held that loss causation requires an allegation that, "if the facts had been as represented by the defendants[,] the value of the [investment] * * * would not have declined," *id.* at 682, or, put differently, that "but for the circumstances that the fraud concealed, the investment that [the plaintiffs] were induced by the fraud to make would not have lost its value," *id.* at 683. In *Bastian*, the Seventh Circuit affirmed the dismissal of a complaint alleging that the defendants' fraudulent statements had induced the plaintiffs to invest in oil and gas limited partnerships that ultimately became worthless, because the complaint did not allege that "the plaintiffs' loss was due to the defendants' fraud" rather than (for example) "the unexpected drop in oil prices." *Id.* at 684. While *Bastian*, like *Emergent Capital*, was not a fraud-on-the-market case, the Seventh Circuit has since made clear that the loss-causation standard applied in that case "applies equally to fraud-on-the-market cases [and] to direct reliance cases." *Roots P'ship* v. *Lands' End, Inc.*, 965 F.2d 1411, 1419 (1992).

3. In addition to citing its own decision in *Knapp* and the Second Circuit's decision in *Suez Equity Investors* as support for its loss-causation standard, the court of appeals cited (Pet. App. 9a) the Eighth Circuit's decision in *Gebhardt* v. *ConAgra Foods, Inc.*, 335 F.3d 824 (2003). Petitioners and their amicus (SIA Br. 3) agree that the Eighth Circuit is aligned with the Ninth Circuit, in that it "appears to accept the artificial price inflation theory in interpreting loss causation." Pet. 13. But the Eighth Circuit's position on this issue is less than clear. It is true that both of the Eighth Circuit decisions cited by petitioners (*ibid.*), including *Gebhardt*, can be read to say that loss causation, like reliance, see *Basic Inc.* v. *Levinson*, 485 U.S. 224, 241-249 (1988), should be presumed in a fraud-on-the-market case. See *Gebhardt*, 335 F.3d at 831; *In re Control Data Corp. Secs. Lit.*, 933 F.2d 616, 618-621 (8th Cir.), cert. denied, 502 U.S. 967 (1991). But each of those decisions also includes language suggesting agreement with the majority view. See *Gebhardt*, 335 F.3d at 831 (plaintiffs "demonstrated loss causation" by pleading that "a decline in the value of their stock" was caused by "the company's misbehavior"); *In re Control Data Secs. Lit.*, 933 F.2d at 621 ("The class presented evidence of a sufficient 'causal nexus' between [the defendant's] improper accounting and the drop in [its] stock price, so that a reasonable jury could find causation.").

4. Respondents correctly identify Ninth Circuit decisions that are consistent with the majority view. Br. in Opp. 8-10. All of those decisions, however, predate the decision in this case. Moreover, there are other Ninth Circuit decisions, followed by the court of appeals here (Pet. App. 9a), that disagree with the majority view on loss causation, and the Ninth Circuit denied, without dissent, a petition for rehearing en banc (*id.* at 52a-53a) in which petitioners asked the court to resolve what they characterized as an intra-circuit conflict (Pet. for Panel Reh'g and Reh'g En Banc 6-9). Under these circumstances, it is reasonable to conclude that the decision below will be viewed as the law of the Ninth Circuit on loss causation both by future panels and by district courts.

B. The Court Of Appeals' Decision Is Incorrect

1. In a Rule 10b-5 action brought by a private party, the plaintiff must prove that he suffered an injury that was

caused by the defendant's misrepresentations. As the court of appeals correctly recognized, the causation requirement encompasses both transaction causation—"that the violations in question caused the plaintiff to engage in the transaction"—and loss causation—"that the misrepresentations or omissions caused the harm." Pet. App. 8a (quoting *Binder* v. *Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999), cert. denied, 528 U.S. 1154 (2000)). Loss causation had long been a judicially inferred element of a Rule 10b-5 claim, see *Bastian*, 892 F.2d at 683-685, and for nearly a decade it has been a statutory element by virtue of the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737. As amended by the PSLRA, the Exchange Act, in a provision titled "Loss causation," requires a plaintiff in a private action to prove that "the [challenged] act or omission of the defendant * * * caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. 78u-4(b)(4). Under the court of appeals' view of loss causation, an investor's loss in a fraud-on-the-market case "occurs at the time of the transaction," when he is harmed by paying too much for the security, and a causal link exists because the defendant's misrepresentation inflated the price. Pet. App. 9a. That holding is incorrect.

A material misrepresentation that reflects an unduly favorable view of a company, when disseminated to the investing public, will typically raise the price of the company's stock, because the price of a security traded in an efficient market ordinarily reflects all publicly available information. See *Basic Inc.* v. *Levinson*, 485 U.S. at 241-249. The artificial inflation will not be reduced or eliminated until the market price reflects the true facts that had been concealed by the fraud. This will most commonly occur when the truth is revealed in whole or in part through a corrective disclosure. That, however, is not the only way the fraud may be

revealed. Events may also effectively disclose the truth. See, *e.g.*, *Suez Equity*, 250 F.3d at 93-94.

Because "the cost of the alleged misrepresentation" will be "incorporated into the value of the security" until that time, the investor who purchased the security will be able to recoup part or all of his overpayment "by reselling the security at the inflated price." *Semerenko*, 223 F.3d at 185. For that reason, it cannot be said that an investor in a fraud-on-the-market case who purchases a security at an inflated price has suffered *any* loss at the time of purchase, much less one caused by the defendant's misrepresentation. See *Robbins*, 116 F.3d at 1448. Measuring the loss in such a case as of the time of purchase, and not requiring any allegation of a subsequent loss of value attributable to the fraud, would grant a windfall to investors who sold before the reduction or elimination of the artificial inflation, because they would recover the portion of the purchase price attributable to the fraud on resale, and then would be entitled to recover that same amount again in damages.

The court of appeals' decision is also erroneous because it renders loss causation effectively indistinguishable from transaction causation, as both the Second Circuit and the Eleventh Circuit have observed. See *Emergent Capital*, 343 F.3d at 198; *Robbins*, 116 F.3d at 1448. Under the Ninth Circuit's approach, transaction causation requires a showing that a material misrepresentation caused the plaintiff to purchase the stock, while loss causation requires a showing that the misrepresentation caused the stock to be purchased at an inflated price. Pet. App. 8a-9a. But since a fundamental premise of the fraud-on-the-market theory is that the dissemination of a material misrepresentation "typically affects the price of the stock," *Peil* v. *Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986), quoted in *Basic Inc.* v. *Levinson*, 485 U.S. at 244, proof that the plaintiff purchased stock in an efficient market after the defendant made a material misrepresenta-

tion will, in the Ninth Circuit, establish transaction causation and loss causation simultaneously. Such a result is difficult to reconcile with the well-established principle that transaction causation and loss causation are distinct elements of a Rule 10b-5 cause of action.

Though it was not relied upon by the court below, there is arguably some support for the Ninth Circuit's standard in the legislative history of the PSLRA. The section of the Conference Report that discusses the applicable loss-causation provision states that a plaintiff must plead and prove that the misrepresentation "actually caused the loss incurred by the plaintiff," and then says the following: "For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission." H.R. Conf. Rep. No. 369, 104th Cong., 2d Sess. 41 (1995). That "example," if construed to be an exhaustive description of the plaintiff's burden, would be essentially identical to the Ninth Circuit's standard. But the entire discussion of the loss-causation provision in the Conference Report is only two sentences long, and the Report does not elaborate on the "example" it provides or explain whether additional items of proof would also be required. For those reasons, and because of the flaws in the Ninth Circuit's standard identified above, it is not likely that this lone sentence in the PSLRA's legislative history reflects a considered congressional judgment regarding how loss causation is to be established in a Rule 10b-5 case. A contrary conclusion would be particularly unwarranted in view of the PSLRA's purpose, which was to impose stricter requirements on plaintiffs in private securities-fraud actions.

2. As formulated by petitioners, and by the courts in the cases on which petitioners rely, the loss-causation standard requires a decline in the stock's price. That formulation may simply reflect the fact that, as in most securities-fraud cases,

there was in fact a decline in price in this case and the others that petitioners cite. A decline in price may not be a necessary condition for loss causation, however, because the inflation attributable to fraud could be reduced or eliminated even if there were a net increase in price. That could happen, for example, if the company corrected the false information and at the same time issued unrelated positive information. Thus, while it is ordinarily a decline in the price of stock that harms investors, they can also be harmed "[i]f a stock does not appreciate as it would have absent the fraudulent conduct," *Gebhardt*, 335 F.3d at 831-832, so that their profit is smaller than it would otherwise have been. As Judge Easterbrook has observed, "a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counterbalancing the loss." *Goldberg* v. *Household Bank, F.S.B.*, 890 F.2d 965, 966 (7th Cir. 1989).

C. The Question Presented Is One Of Recurring Importance

The question presented in the petition does not directly affect the government's ability to enforce the federal securities laws, because loss causation is not an element of a securities-fraud case in a criminal prosecution or civil enforcement action brought, respectively, by the Department of Justice or the Securities and Exchange Commission. The issue is nevertheless one of recurring importance.

What a plaintiff must plead and prove to establish loss causation in a fraud-on-the-market case is a recurring question because of the large number of securities-fraud class actions that are filed in federal court. According to one study, an average of approximately 190 such cases were filed annually between 1996 and 2003. See Cornerstone Research, *Securities Class Action Case Filings—2003: A Year in Review* 3 Exh. 2 (2004), *available at* http:

//securities.stanford.edu/clearinghouse_research/2003_YIR/2003051104.pdf. A large plurality of those cases—an average of 51 per year—were filed in the Ninth Circuit. *Id.* at 13 Exh. 12. Because loss causation is an essential element of a private plaintiff's Rule 10b-5 claim, see 15 U.S.C. 78u-4(b)(4), and because the overwhelming majority of securities-fraud class actions allege a violation of Rule 10b-5, see Cornerstone Research, *supra*, at 15, 16 Exh. 14, the pleading requirements for loss causation will be relevant in a large number of cases, about a quarter of which arise in the Ninth Circuit. The court of appeals' decision could affect the outcome of any one of those cases in which the plaintiffs' sole allegation of loss causation is that the price of the stock they purchased was inflated by the defendants' fraud.

The question presented in the petition is also an important one. As this Court "repeatedly ha[s] emphasized," private securities-fraud actions are a "necessary supplement" to criminal and civil enforcement actions. *Bateman, Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964)). The principal reason the government brings such enforcement cases is to ensure the integrity of the securities markets, and thereby protect the investing public. Those objects, however, are likely to be hindered rather than furthered by permitting private securities-fraud suits to proceed past the pleading stage without any allegation that the plaintiffs suffered a loss attributable to the fraud. By requiring issuers of securities to expend time and resources litigating, and in most cases settling, such lawsuits, the Ninth Circuit's decision is more likely to harm than to aid "the intended beneficiaries" of Rule 10b-5. *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994).

D. This Case Is A Suitable Vehicle For Resolving The Circuit Conflict

1. Because the court of appeals reversed the district court's dismissal of the complaint and remanded for further proceedings, its decision is interlocutory. While this Court ordinarily does not grant certiorari to review interlocutory decisions, that is not an invariable rule. Indeed, in many of this Court's leading decisions on Rule 10b-5, certiorari was granted after the court of appeals had reversed either the dismissal of the complaint or a grant of summary judgment for the defendants.[2] In those cases, the interlocutory posture of the case may have been thought to be no obstacle to review because the court of appeals had "decided an important issue, otherwise worthy of review, and Supreme Court intervention [could] serve to hasten or finally resolve the litigation." Robert L. Stern et al., *Supreme Court Practice* § 4.18, at 260 (8th ed. 2002). That is equally true here.

A related reason for not applying the general rule against review of interlocutory decisions in a case of this type is that a large proportion of securities-fraud class actions are effectively decided at the pleading stage. If a motion to dismiss is granted and affirmed on appeal, the defendants will prevail. But if a motion to dismiss is denied, or if it is granted but reversed on appeal, the costs of pre-trial litigation, combined with the risks of a substantial damages award, will in most cases lead the defendants to settle. According to a recent study, "[f]ully 80 percent of federal securities class action

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[2] See *Central Bank of Denver*, 511 U.S. at 168-169 (aiding and abetting); *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350, 353-354 (1991) (statute of limitations); *Basic Inc.* v. *Levinson*, 485 U.S. at 228-229 (materiality and reliance); *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 468-470 (1977) (breach of fiduciary duty); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 191-193 (1976) (scienter); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 727 (1975) (purchase or sale).

lawsuits end in settlement." Elaine Buckberg et al., *Recent Trends in Securities Class Action Litigation: 2003 Update*, 5 Class Action Litig. Rep. 304, 305 (2004). Because of the probability of settlement, this is not likely to be a case in which petitioners could "rais[e] the same issue[] in a later petition, after final judgment has been rendered." *Virginia Military Inst.* v. *United States*, 508 U.S. 946 (1993) (Scalia, J., respecting denial of certiorari).

2. If the Court does grant certiorari and resolves the loss-causation issue, it is possible that the case will ultimately be decided on some other ground, because there are issues unrelated to loss causation that the court of appeals directed the district court to address on remand. One of those issues is whether the totality of respondents' allegations are adequate to show that petitioners made knowingly false statements concerning Ceclor CD. Pet. App. 14a. The other is whether any of the allegations concerning either Ceclor CD or Albuterol Spiros are subject to dismissal for reasons the district court has not yet considered. *Id.* at 16a. Thus, even if this Court reversed the judgment of the court of appeals, the case would still proceed, albeit in a more limited form, if, on remand, the district court found that the allegations concerning Ceclor CD are sufficient and rejected respondents' alternative arguments for dismissal. And even if this Court *affirmed* the judgment of the court of appeals, the complaint would still be dismissed if, on remand, the district court found that the Ceclor CD allegations are *not* sufficient and found merit in respondents' alternative arguments for dismissal of the Albuterol Spiros allegations. But the mere possibility that the parties that won in this Court would lose on some other ground in the lower courts should not be an obstacle to certiorari, particularly since the court of appeals has given no indication of how any of the pending issues should be resolved. See *id.* at 14a n.5 (expressing "no opinion" on whether allegations concerning Ceclor CD "in

totum rise to the level necessary for scienter"); *id.* at 16a (stating that "it would be improper" for court of appeals to decide issues not addressed by district court).

3. Respondents contend that the facts of this case satisfy not only the loss-causation standard applied by the court of appeals but also the one that petitioners advocate, and that the choice of standards will thus have no effect on the outcome. Br. in Opp. 4-6. They argue that, even if there must be "a drop in a security's price upon disclosure of the truth," that is what happened here, because Dura announced in November 1998 that the FDA would not approve Albuterol Spiros and the price of its stock declined the next day. *Id.* at 5. That, however, is not the allegation of loss causation in the complaint. Consistent with the standard ultimately endorsed by the court of appeals, the complaint alleges simply that respondents "were damaged" because, "[i]n reliance on the integrity of the market, they paid artificially inflated prices for Dura securities." Resp. C.A. E.R. Tab 72, at 85 (¶ 179). See Resp. C.A. Br. 18 (arguing that this allegation satisfies element of loss causation); Mem. of Points & Authorities in Opp. to Mot. to Dismiss 40 (same). Insofar as there are any allegations of a corrective disclosure followed by a decline in the stock price, moreover, those allegations relate to the February 1998 announcement concerning Ceclor CD. Resp. C.A. E.R. Tab 72, at 17 (¶ 32), 61-62 (¶ 134). Thus, if respondents wish to rely upon the November 1998 corrective disclosure and price decline, they will have to amend their complaint, as they implicitly acknowledged in the court of appeals. See Pet. C.A. Br. 21 ("[I]f plaintiffs were required to plead a stock drop upon a corrective disclosure, the district court should have permitted them to do so in an amended complaint.").

If the Court granted certiorari and reversed the court of appeals' judgment, it is possible that respondents would request, and that the courts below would grant, leave to

amend the complaint to include an allegation of loss causation based on the November 1998 disclosure concerning Albuterol Spiros and the subsequent decline in price. But it is also possible that leave to amend on that ground would not be sought, or that, if it were, it would be denied, because amending the complaint to satisfy the majority view on loss causation might require more fundamental amendments. For example, alleging one loss in February 1998 and a second loss in November 1998 would create two categories of class members: those who sold their stock between February and November (and could recover only for the first loss), and those who held it through November (and could recover for both). That, in turn, might require the creation of subclasses, see Fed. R. Civ. P. 23(c)(4)(B), and might raise questions about the standing of some or all of the proposed class representatives. While these considerations might not in the end foreclose an amendment of the complaint that would satisfy the loss-causation standard advocated by the United States, there is sufficient doubt about that issue that the possibility of amendment should not be a ground for denying certiorari.

4. A final reason to grant certiorari, rather than await another case that presents the same question, is that there might not be such a case suitable for certiorari review for some time. If certiorari were denied here, defendants in future Rule 10b-5 cases in the Ninth Circuit would be unable to seek dismissal of a complaint that alleged loss causation on the sole basis of an artificially inflated purchase price, and if there were such a motion it would be denied. Since the denial of a motion to dismiss is ordinarily not appealable, and since most securities-fraud class actions settle before trial, the Ninth Circuit might not have an opportunity to address this question again for some time. And while review by this Court could be sought in a case in which some other court of appeals affirmed the dismissal of a complaint that did not

satisfy the loss-causation standard followed by the majority of the courts of appeals, petitioners' amicus may well be correct that many class-action counsel would be reluctant to seek certiorari in such a case because of the risk of affirmance, which would make that standard applicable nationwide. See SIA Br. 6.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC., *et al.*,

Petitioners,

v.

MICHAEL BROUDO, *et al.*,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

MOTION FOR LEAVE TO FILE A BRIEF AS *AMICUS CURIAE* AND BRIEF FOR THE SECURITIES INDUSTRY ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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MOTION OF THE SECURITIES INDUSTRY ASSOCIATION FOR LEAVE TO FILE A BRIEF AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

The Securities Industry Association ("SIA") hereby requests, pursuant to Rule 37.2 of the Rules of this Court, leave to file the accompanying brief as *amicus curiae* in support of Petitioners. SIA obtained the consent of the Petitioners. Petitioners' letter of consent has been filed with the Clerk of the Court. Respondents, however, withheld their consent from the filing of this brief in support of the Petition.

SIA offers this brief because the issues to be decided affect the interests of the SIA and its members. SIA was established in 1972 to represent the shared interests of nearly 600 securities firms. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The SIA has previously filed *amici* briefs with the Court in cases concerning civil liability under the

federal securities laws. See, *e.g.*, *Howsam* v. *Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002); *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350 (1991); *Rodriguez De Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989); *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220 (1987).

The question presented by this case – the proper test for establishing "loss causation" in securities fraud cases – is an issue of recurring importance for the securities industry and investors. It is critically important to the SIA that member firms not be converted into guarantors that investments will be successful where no causal connection exists between the misrepresentation alleged and a security's decline in price. It is equally important that a uniform rule of federal law be applied across the country. The vast majority of SIA members have nationwide operations, and a patchwork of rules undermines the Congressional policy favoring national markets. The SIA therefore has a vital interest in the issue presented in this case and the SIA's views can assist the Court in deciding whether certiorari should be granted.

For the foregoing reasons, SIA's Motion for Leave to File a Brief as *Amicus Curiae* in support of Petitioners should be granted.

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Cornerstone Research, *Securities Class Action Case Filings – 2002: A Year in Review* (2003), *available at* http://securities.stanford.edu/clearinghouse_research_2002_YIR/2002_yir.pdf 5, 6

INTEREST OF THE *AMICUS CURIAE*[1]

The Securities Industry Association ("SIA"), established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $304 billion in global revenues. (More information about SIA is available on its home page: www.sia.com).

The question presented by this case – the proper test for establishing "loss causation" in securities fraud cases – is an issue of recurring importance for the securities industry and investors. It is critically important to the SIA that member firms not be converted into guarantors that investments will be successful where no causal connection exists between the misrepresentation alleged and a security's decline in price. It is equally important that a uniform rule of federal law be applied across the country. The vast majority of SIA members have nationwide operations, and a patchwork of rules undermines the Congressional policy favoring national markets. The SIA therefore has a vital interest in the issue presented in this case and the SIA's views can assist the Court in deciding whether certiorari should be granted.

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[1] Pursuant to this Court's Rule 37.6, *amicus* Securities Industry Association states that no counsel for any party authored this brief in whole or in part, and no person or entity made a monetary contribution to the preparation or submission of the brief.

INTRODUCTION

Compelling reasons warrant granting certiorari. The petition presents an acknowledged conflict between a growing number of circuits. The conflict concerns a central issue – loss causation – that is contested in the vast majority of securities cases. There are hundreds of filed securities cases in the pipeline in which loss causation is a critical issue. Only a decision by this Court will resolve this recurring and important issue.

REASONS FOR GRANTING THE PETITION

I. THIS CASE PRESENTS AN ACKNOWLEDGED, ESTABLISHED, AND LONGSTANDING CIRCUIT SPLIT THAT WILL NOT BE RESOLVED WITHOUT INTERVENTION BY THIS COURT.

The Ninth Circuit's decision below acknowledges, extends, and perpetuates a longstanding conflict among the circuits on the proper test for establishing the "loss causation" element of a claim under Rule 10b-5 of the Securities Exchange Act of 1934. "Loss causation" is "the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." *Emergent Capital Inv. Mgmt., LLC* v. *Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003). "Loss causation" is the securities law equivalent to the common law tort rule of proximate cause. *Id.* ("We have often compared loss causation to the tort law concept of proximate cause"); *Bastian* v. *Petren Res. Corp.*, 892 F.2d 680, 683 (7th Cir. 1990) ("[W]hat securities lawyers call 'loss causation' *is* the standard common law fraud rule".) "The proximate cause [or loss causation] element of the claim prevents section 10(b) and Rule 10b-5 from becoming a system of investor insurance." *Rousseff* v. *E.F. Hutton Co.*, 843 F.2d 1326, 1329 (11th Cir. 1988).

Under the Ninth Circuit's decision, a plaintiff in a securities fraud case satisfies the "loss causation" element of a claim under Rule 10b-5 merely by pleading and proving that the company's share price was inflated when the plaintiff purchased shares. *See* Pet. App. 9a ("[L]oss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause."). The Eighth Circuit also follows this approach. *Abbey* v. *Control Data Corp. (In re Control Data Corp. Sec. Litig.)*, 933 F.2d 616, 619-20 (8th Cir. 1991); *Gebhardt* v. *ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

In the Second, Third, Seventh, and Eleventh Circuits, by contrast, the plaintiff must allege and prove that the company's share price declined when the allegedly concealed information was disclosed, and any damages are limited to that decline. *Emergent Capital*, 343 F.3d at 198-99; *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 184-85 (3d Cir. 2000); *Bastian*, 892 F.2d at 684-85; *First Interstate Bank of Nev., N.A.* v. *Chapman & Cutler*, 837 F.2d 775, 779-80 (7th Cir. 1988); and *Robbins* v. *Koger Props., Inc.*, 116 F.3d 1441, 1447-49 (11th Cir. 1997).

An illustration will demonstrate the vastly different outcomes under the conflicting approaches. Suppose plaintiff P buys $200 of stock in defendant D. As time passes, the value of P's investment declines to $20. *After* this decline, D announces the restatement of an accounting item. After this announcement, the value of P's shares remains at $20. P brings a lawsuit under Rule 10b-5. In the Second, Third, Seventh, and Eleventh Circuits, the no-decline case is dismissed on a Rule 12(b)(6) motion.[2] In contrast, in the Ninth and Eighth Circuits, P's lawyers bring a class action

[2] Of course, in every circuit, loss causation properly may be alleged in the classic situation when the announcement causes a share price decline.

and hire an expert who opines on how much of the price P paid was "inflated" because of the undisclosed accounting issue. In these circuits, the no-decline case likely results in discovery, summary judgment motions, often settlement, and sometimes trial. Across the mass of securities cases, the difference between the two conflicting approaches affects hundreds of millions of dollars in damage awards, settlements, attorneys' fees, and costs imposed on the federal judicial system.

As the 1997-2003 dates of the cited cases on both sides of this conflict demonstrate, see *supra*, at 3, the circuit courts have found nothing in the Private Securities Litigation Reform Act of 1995 (or any subsequent legislation) that resolves this conflict. Only a decision by this Court will resolve the doctrinal divide.

This conflict has been expressly acknowledged by the circuits for at least six years. The Eleventh Circuit acknowledged the conflict in 1997 in *Robbins*. 116 F.3d at 1448 (noting that the Eighth and Ninth Circuits have held that "plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation," but holding that "we refuse to do so here") (internal quotation marks omitted). And in the decision below, the Ninth Circuit expressly acknowledged that its holding conflicts with decisions of the Third and Eleventh Circuits. Pet. App. 9a n.4 ("By contrast, other circuits are less favorable to plaintiffs and do require demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint.") (citing *Semerenko* and *Robbins*). See also *In re Initial Pub. Offering Sec. Litig.*, No. 21 MC 92 (SAS), 2003 WL 23096875, at *2 (S.D.N.Y. Dec. 31, 2003) ("The Courts of Appeals are deeply divided on this question. The Eighth and Ninth circuits have recently reaffirmed their holding that allegations of artificial inflation, alone, *are* sufficient. The Third and the Eleventh circuits have held otherwise.") (footnotes omitted); David S.

Escoffery, Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 Fordham L. Rev. 1781, 1797-1809 (2000) (discussing the circuit conflict).

The Ninth Circuit's decision perpetuates this acknowledged conflict. In addition, the recent vintage of the court of appeals' decisions perpetuating the conflict demonstrates that only action by this Court will resolve the conflict over "loss causation" in securities fraud cases.

II. THE CIRCUIT SPLIT NEEDS TO BE RESOLVED BECAUSE IT PRESENTS A FREQUENTLY-LITIGATED ISSUE THAT SIGNIFICANTLY AFFECTS THE SECURITIES INDUSTRY AND INVESTORS.

The Court should resolve the circuit conflict because the proper standard for loss causation is a recurring and frequently-litigated issue in securities fraud cases. Securities lawsuits are proliferating as a result of the broad stock market declines between early 2000 and March 2003. See, *e.g.*, Cornerstone Research, *Securities Class Action Case Filings – 2002: A Year in Review* 2 (2003), *available at* http://securities.stanford.edu/clearinghouse_research/2002_YIR/2002_yir.pdf (reporting that the 224 securities class action suits filed in 2002 was "31 percent greater than the number of cases filed in 2001 [171] and the second highest of any year since the passing of the Private Securities Litigation Reform Act of 1995") (brackets in original); *id.* at 17 (noting that 85 percent of the cases filed in 2002 involved Rule 10b-5 claims). Accordingly, there are many securities cases in the federal court pipeline that are affected by this conflict. This Court should resolve the conflict before numerous cases in the pipeline are decided incorrectly and judicial resources are wasted.

The lack of a uniform rule on loss causation is intolerable. As matters now stand, litigants in different circuits are subject

to different legal standards with respect to this outcome determinative issue. Indeed, the Ninth Circuit's expansion of the conflict is particularly significant because it means that the circuits in which the largest number of securities fraud cases are filed now have conflicting rules. See *id.* at 14 (the top circuits in number of filings have been the Second, Third, Ninth and Eleventh Circuits). The inconsistent legal standards in those circuits result in diametrically opposed outcomes for indistinguishable cases. It is therefore important that the Court resolve the conflict before many more cases are wrongly decided, resulting in either inappropriate liability imposed on defendants or no redress for legitimate victims.

Moreover, the Court should take this case to review the conflict because the class action plaintiffs' bar has shown that it is not likely to seek certiorari when it loses on loss causation so long as one or more circuits favors its position. In *Robbins*, the Eleventh Circuit reversed an $81 million class action judgment for the plaintiff class and acknowledged a conflict with the Ninth Circuit, 116 F.3d at 1446, 1448. Nonetheless, the nation's leading plaintiffs' class-action law firm did not seek certiorari in *Robbins*. Rather, as long as the plaintiffs' bar can forum shop because some circuit has favorable loss causation rules (and the plaintiffs' bar can bring new, nationwide class actions in a district court within the circuit), the plaintiffs' bar has every incentive to leave the conflict festering.

The interlocutory posture of this case does not render it an inappropriate vehicle for resolving this important circuit conflict. This Court has granted certiorari to resolve important Rule 10b-5 issues in other cases involving circuit court reversals of Rule 12(b)(6) dismissals of complaints. *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 469 (1977) (establishing that Rule 10b-5 does not cover mismanagement or breach of fiduciary duty); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 727 (1975) (establishing that

private Rule 10b-5 plaintiff must be a purchaser or seller). The proper standard for loss causation is a pure question of law that can be fully addressed at the Rule 12(b)(6) stage. Indeed, in this case, the district court used the proper standard and granted petitioner's Rule 12(b)(6) motion. Pet. App. 40a.

Amicus believes that it is particularly important for this Court to grant review to establish a loss causation rule that results in the dismissal of cases where there is no injury at the Rule 12(b)(6) motion to dismiss stage. This Court has recognized that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. As a result, defendants "expend large sums even for pretrial defense and the negotiation of settlements" when cases without merit are not dismissed at an appropriately early stage. *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994). This Court has noted that the "ripple effects" of such "uncertainty and excessive litigation" under Rule 10b-5 can include increased "litigation and settlement costs," which may be passed on to companies and their investors, and which can make professionals reluctant to work with newer and smaller companies. *Id.*[3]

The real-world effects of the unresolved conflict on loss causation extend beyond the impact on particular litigants. *Amicus* believes the standard set by the Ninth Circuit will impose liability when no damage has been caused by the defendants. This gives securities issuers, investment firms, and professionals a strong disincentive to undertake or

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[3] The absence of a private civil remedy under the federal securities laws in cases where the plaintiff has suffered no injury does not affect federal and state administrative and criminal remedies that are otherwise available against wrongdoers even when there is no financial loss. *See Bastian*, 892 F.2d at 685 ("Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities.").

participate in securities transactions beneficial to our market economy. The resulting suppression of a robust securities market is harmful to the entire economy and is in nobody's interest. See *Bastian*, 892 F.2d at 685 ("No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation.").

At present, the loss causation standard is set on a circuit-by-circuit basis and different courts have set opposing rules. The resulting lack of uniformity causes inconsistent outcomes for litigants and uncertainty for participants in the securities markets. The Court should resolve the issue presented in this case now in order to set a clear rule and avoid the undesirable economic effects fostered by the acknowledged circuit split.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

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(11)

Supreme Court, U.S.
FILED
SEP 13 2004
OFFICE OF THE CLERK

No. 03-932

IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

JOINT APPENDIX

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PETITION FOR CERTIORARI FILED DECEMBER 4, 2003
CERTIORARI GRANTED JUNE 28, 2004

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APPENDIX A — RELEVANT DOCKET ENTRIES OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BROUDO, et al. v. DURA PHARMACEUTICALS, et al.

01-57136

General Docket
US Court of Appeals for the Ninth Circuit
Court of Appeals Docket #: 01-57136
Nsuit: 3850 SEC (Fed)
Broudo, et al v. Dura Pharmaceuticals, et al
Appeal from: Southern District of California (San Diego)

- -

Case type information:
1) civil
2) private
3)

- -

Lower court information:
District: 0974-3 : CV-99-00151-MJL(NLS)
presiding judge: M. James Lorenz, District Judge
court reporter: Jeanette Hill, Court Reporter
Date Filed: 1/27/99
Date order/judgment: 11/6/01
Date NOA filed: 12/4/01

- -

Appendix A

Fee status: paid

- -

Prior cases:
None
Current cases:
None

Docket as of January 12, 2004 11:15 pm

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GIBSON, DUNN &
CRUTCHER
4 Park Plaza, Suite 1400
Irvine, CA 92714-8557

NISSAN MOTOR CO., a Japanese
corporation
Defendant - Appellee

Appendix A

MICHAEL BROUDO; BALDEV S. GILL;
LARRY MORGAN IRA; LEONID
SHVARTSMAN, (for G&S partnership);
NEIL SISKIND; ROBERTA SPECK;
BRENT VOGT, on behalf of themselves
and all others similarly situated
Plaintiffs - Appellants

v.

DURA PHARMACEUTICALS, INC.;
CAM L. GARNER; JAMES W. NEWMAN;
CHARLES W. PRETTYMAN;
WALTER F. SPATH; JAMES C. BLAIR;
JULIA R. BROWN; JOSEPH C, COOK, JR.;
MITCHELL R. WOODBURY;
MERILL LYNCH AND CO./MERRILL LYNCH,
PIERCE FENNER AND SMITH, INC.;
NISSAN MOTOR CO., a Japanese corporation

Defendants - Appellees

Appendix A

4/29/02	Filed original and 15 copies Appellants opening brief (Informal: NO) 39 pages; 5 excerpts of record (1 Exc.vol); served on 4/19/ 02 (minor defcy: (Missing Stmt Rel Cs)) Notified counsel. minor brief deficiency response due 5/13/02; [01-57136] (mhf)
7/3/02	Filed original and 15 copies appellee Dura Pharmaceuticals's 48 pages brief, & 5 copies of Suppl EOC in 2 vol; served on 7/1/ 02 [01-57136] (mhf)
8/5/02	Filed original and 15 copies Michael Broudo reply brief, (Informal: NO) 34 pages; served on 8/1/02 [01-57136] (mhf)
2/4/03	ARGUED AND SUBMITTED TO Harry PREGERSON, Stephen R. REINHARDT, Glenn L. Archer [01-57136] (dr)

Appendix A

8/5/03	FILED OPINION: REVERSED REMANDED (Terminated on the Merits after Oral Hearing; Reversed; Written, Signed, Published. Harry PREGERSON; Stephen R. REINHARDT; Glenn L. Archer, author.) FILED AND ENTERED JUDGMENT. [01-57136] (mhf)
8/19/03	Filed original and 50 copies Appellees' petition for panel rehearing and petition for rehearing en banc 14 p.pages, served on 8/18/03 (PANEL & ALL ACTIVE JUDGES) [01- (mhf)
9/29/03	Filed order (Harry PREGERSON, Stephen R. REINHARDT, Glenn L. Archer,): The pet for rehearing & the suggestion for rehearing en banc is rejected. [01-57136] (mhf)

APPENDIX B — RELEVANT DOCKET ENTRIES OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA

U.S. District Court

Southern District of California (San Diego)

CIVIL DOCKET FOR CASE #: 99-CV-151

Broudo, et al v. Dura Pharmaceuticals, et al

Filed: 01/27/99
Assigned to: Judge M. James Lorenz
Referred to: Magistrate Judge William McCurine, Jr.
Demand: $0,000
Nature of Suit: 850
Lead Docket: None
Jurisdiction: Federal Question
Dkt# in other court: None
Cause: 15:78m(a) Securities Exchange Act

MICHAEL BROUDO plaintiff	William S Lerach (619)231-7423 [COR LD NTC] Lerach Coughlin Stoia Geller Rudman and Robbins 401 B Street Suite 1700 San Diego, CA 92101 (619)231-1058

Appendix B

Michael D Donovan
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ROBERT JOHNSON plaintiff	William S Lerach (See above) [COR LD NTC]
FAYE WRIGHT plaintiff	William S Lerach (See above) [COR LD NTC]
RONALD L FUTTERMAN, as Trustee for the Futterman & Howard, Chtd. Employee Profit Sharing T[illegible] plaintiff	William S Lerach (See above) [COR LD NTC]
DAVID DANIS plaintiff	William S Lerach (See above) [COR LD NTC]

v.

Appendix B

DURA PHARMACEUTICALS, INC. defendant	William F Sullivan (858)720-2555 [COR LD NTC] Paul Hastings Janofsky and Walker 3579 Valley Centre Drive San Diego, CA 92130 (858)720-2500
CAM L GARNER defendant	William F Sullivan (See above) [COR LD NTC]
JAMES W NEWMAN defendant	William F Sullivan (See above) [COR LD NTC]
CHARLES W PRETTYMAN defendant	William F Sullivan (See above) [COR LD NTC]
WALTER F SPATH defendant	William F Sullivan (See above) [COR LD NTC]
JAMES C BLAIR defendant	William F Sullivan (See above) [COR LD NTC]

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JULIA R BROWN defendant	William F Sullivan (See above) [COR LD NTC]
JOSEPH C COOK, JR defendant	William F Sullivan (See above) [COR LD NTC]
MITCHELL R WOODBURY defendant	William F Sullivan (See above) [COR LD NTC]
MERRILL LYNCY AND CO., INC./MERRILL LYNCH, PIERCE FENNER AND SMITH, INC. defendant	J Anthony Sinclitico, III (619)544-8190 [COR LD NTC] Gibson Dunn and Crutcher 4 Park Plaza Irvine, CA 92614-8557 (949)451-3800
NISSAN MOTOR CO., a Japanese Corporation defendant	

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SCOTT ROTHSTEIN, behalf of themselves and all others similarly situated plaintiff	OnWilliam S Lerach (619)231-7423 [COR LD NTC] Lerach Coughlin Stoia Geller Rudman and Robbins 401 B Street Suite 1700 San Diego, CA 92101 (619)231-1058
STUART GOLLOMP, On behalf of themselves and all others similarly situated plaintiff	William S Lerach (See above) [COR LD NTC]
JEFF BEDARD, On behalf of themselves and all others similarly situated plaintiff	William S Lerach (See above) [COR LD NTC]
ROBERTA SPECK, On behalf of Herself and All Others Similarly Situated plaintiff	William S Lerach (See above) [COR LD NTC] William F Sullivan (858)720-2555 [COR LD NTC] Paul Hastings Janofsky and Walker 3579 Valley Centre Drive San Diego, CA 92130 (858)720-2500

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PELICAN FINANCIAL, L.L.C., On behalf of itself and all others similarly situated plaintiff	William S Lerach (See above) [COR LD NTC]
MARTHA A DEADRICK, On behalf of herself and all others similarly situated plaintiff	Jeffrey R Krinsk (619)238-5425 [COR LD NTC] Finkelstein and Krinsk 501 West Broadway Suite 1250 San Diego, CA 92101-3593 (619)238-1333

v.

PIERCE FENNER & SMITH, INC
defendant

MICHAEL MARTY plaintiff	Timothy J Burke (310)209-2087 [COR LD NTC] Stull Stull and Brody 10940 Wilshire Boulevard Suite 2300 Los Angeles, CA 90024-3907 (310)209-2468

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DOCKET PROCEEDINGS

DATE #	DOCKET ENTRY
1/27/99 1	Complaint Filed; (referred to Magistrate James F. Stiven) Receipt No/Amt of Fee: 45763/$150 (jrl) [Entry date 01/28/99] [3:99cv151]
10/7/99 37	Consolidated and Amended complaint [1-1]; demand jury trial (kjl) [Entry date 10/08/99] [3:99cv151]
11/22/99 39	Notice of Motion and Motion by defendant Mitchell R Woodbury in 3:99-cv-00151, defendant Joseph C Cook Jr in 3:99-cv-00151, defendant Julia R Brown in 3:99-cv-00151, defendant Walter F Spath in 3:99-cv-00151, defendant Charles W Prettyman in 3:99-cv-00151, defendant James W Newman in 3:99-cv-00151, defendant Cam L Garner in

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	3:99-cv-00151, defendant Dura Pharmaceuticals in 3:99-cv-00151 to dismiss consolidated and amended cmp pursuant to FRCP 9(b) and 12(b)(6) [motion(s) referred to Judge M. J. Lorenz]; motion hrg set for 2/28/00 at 10:00 am (meg) [Entry date 11/23/99] [3:99cv151]
11/22/99 40	Memorandum of points and authorities by defendant Mitchell R Woodbury in 3:99-cv-00151, defendant Joseph C Cook Jr in 3:99-cv-00151, defendant Julia R Brown in 3:99-cv-00151, defendant Walter F Spath in 3:99-cv-00151, defendant Charles W Prettyman in 3:99-cv-00151, defendant James W Newman in 3:99-cv-00151, defendant Cam L Garner in 3:99-cv-00151, defendant Dura Pharmaceuticals in 3:99-cv-00151 in support of

	motion to dismiss consolidated and amended cmp pursuant to FRCP 9(b) and 12(b)(6) [39-1] (meg) [Entry date 11/23/99] [3:99cv151]
11/22/99 43	Request for Judicial Notice by defendant Mitchell R Woodbury in 3:99-cv-00151, defendant Joseph C Cook Jr in 3:99-cv-00151, defendant Julia R Brown in 3:99-cv-00151, defendant Walter F Spath in 3:99-cv-00151, defendant Charles W Prettyman in 3:99-cv-00151, defendant James W Newman in 3:99-cv-00151, defendant Cam L Garner in 3:99-cv-00151, defendant Dura Pharmaceuticals in 3:99-cv-00151 motion to dismiss consolidated and amended cmp pursuant to FRCP 9(b) and 12(b)(6) [39-1] (meg) [Entry date 11/23/99] [3:99cv151]

2/18/00 52	Opposition by plaintiff David Danis in 3:99-cv-00151, plaintiff Ronald L Futterman in 3:99-cv-00151, plaintiff Michael Broudo in 3:99-cv-00151, plaintiff Stuart Gollomp in 3:99-cv-00151, plaintiff Jeff Bedard in 3:99-cv-00151, plaintiff Roberta Speck in 3:99-cv-00151, plaintiff Pelican Financial in 3:99-cv-00151, plaintiff Martha A Deadrick in 3:99-cv-00151, plaintiff Scott Rothstein in 3:99-cv-00151, plaintiff Faye Wright in 3:99-cv-00151, plaintiff Robert Johnson in 3:99-cv-00151 to motion to dismiss consolidated and amended cmp pursuant to FRCP 9(b) and 12(b)(6) [39-1] (jrl) [Entry date 02/18/00] [3:99cv151]

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3/24/00 57	Reply by defendant Mitchell R Woodbury in 3:99-cv-00151, defendant Joseph C Cook Jr in 3:99-cv-00151, defendant Julia R Brown in 3:99-cv-00151, defendant Walter F Spath in 3:99-cv-00151, defendant Charles W Prettyman in 3:99-cv-00151, defendant James W Newman in 3:99-cv-00151 to opposition to motion to dismiss consolidated and amended cmp pursuant to FRCP 9(b) and 12(b)(6) [39-1] (meg) [Entry date 03/27/00] [3:99cv151]
7/12/00 68	Order by Judge M. J. Lorenz granting motion to dismiss consolidated and amended cmp pursuant to FRCP 9(b) and 12(b)(6) [39-1] without prejudice. Plas shall file and serve an amd cmp w/in 60 days of the date of this order is stamped filed. (meg) [Entry date 07/13/00] [3:99cv151]

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9/25/00 72	Second consolidated amended complaint [37-1]; demand for jury trial (meg) [Entry date 09/26/00] [3:99cv151]
11/22/00 75	Notice of Motion and Motion by defendant Dura Pharmaceuticals in 3:99-cv-00151, defendant Cam L Garner in 3:99-cv-00151, defendant James W Newman in 3:99-cv-00151, defendant Charles W Prettyman in 3:99-cv-00151, defendant Walter F Spath in 3:99-cv-00151, defendant Mitchell R Woodbury in 3:99-cv-00151, defendant Joseph C Cook Jr in 3:99-cv-00151, defendant Julia R Brown in 3:99-cv-00151 to dismiss plas' second consolidated and amended cmp pursuant to 12(b)(6), 9(b); [motion(s) referred to Judge M. J. Lorenz] motion hrg set for 3/12/01 at 10:30 (vls) [Entry date 11/24/00] [3:99cv151]

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11/22/00 76	Memorandum of points and authorities by defendant Mitchell R Woodbury in 3:99-cv-00151, defendant Joseph C Cook Jr in 3:99-cv-00151, defendant Julia R Brown in 3:99-cv-00151, defendant Walter F Spath in 3:99-cv-00151, defendant Charles W Prettyman in 3:99-cv-00151, defendant James W Newman in 3:99-cv-00151, defendant Cam L Garner in 3:99-cv-00151, defendant Dura Pharmaceuticals in 3:99-cv-00151 in support of motion to dismiss plas' second consolidated and amended cmp pursuant to 12(b)(6), 9(b); [75-1] (vls) [Entry date 11/24/00] [3:99cv151]

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11/22/00 79	Request for Judicial Notice by defendant Mitchell R Woodbury in 3:99-cv-00151, defendant Joseph C Cook Jr in 3:99-cv-00151, defendant Julia R Brown in 3:99-cv-00151, defendant Walter F Spath in 3:99-cv-00151, defendant Charles W Prettyman in 3:99-cv-00151, defendant James W Newman in 3:99-cv-00151, defendant Cam L Garner in 3:99-cv-00151, defendant Dura Pharmaceuticals in 3:99-cv-00151 motion to dismiss plas' second consolidated and amended cmp pursuant to 12(b)(6), 9(b); [75-1] (vls) [Entry date 11/24/00] [3:99cv151]
2/2/01 83	Memo of points and authorities in Opposition by plaintiffs in 3:99-cv-00151 to motion to dismiss plas' second consolidated and amended cmp pursuant to 12(b)(6), 9(b); [75-1] (meg) [Entry date 02/02/01] [Edit date 02/02/01] [3:99cv151]

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2/20/01	84	Reply by defendant Mitchell R Woodbury in 3:99-cv-00151, defendant Joseph C Cook Jr in 3:99-cv-00151, defendant Julia R Brown in 3:99-cv-00151, defendant Walter F Spath in 3:99-cv-00151, defendant Charles W Prettyman in 3:99-cv-00151, defendant James W Newman in 3:99-cv-00151, defendant Cam L Garner in 3:99-cv-00151, defendant Dura Pharmaceuticals in 3:99-cv-00151 to opposition to motion to dismiss plas' second consolidated and amended cmp pursuant to 12(b)(6), 9(b); [75-1] (meg) [Entry date 02/21/01] [3:99cv151]
11/5/01	95	Order by Judge M. J. Lorenz granting motion to dismiss plas' second consolidated and amended cmp pursuant to 12(b)(6), 9(b); [75-1]. Second consolildated and amended complaint is dismissed with prejudice. Dfts request for judicial

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		notice is granted insofar as the court has relied on those documents. The clerk of the court is directed to enter judgment in this action, and the judgment shall apply to all matters that have been consolidated to the instant master file, in re Dura Securities Litigation 99cv151 L(NLS). (copy of order in member cases) (meg) [Entry date 11/06/01] [Edit date 11/06/01] [3:99cv151]
11/6/01	96	Clerks Judgment: court grants defendant's motion to dismiss plaintiffs' second consolidated and amended complaint. Second consolildated and amended complaint is dismissed with prejudice. Defendants' request for judicial notice is granted insofar as the court has relied on those documents. The clerk of the court is directed to enter judgment in this action, and the judgment shall apply to all matters

	that have been consolidated to the instant master file, in re Dura Securities Litigation 99cv151 L(NLS). terminating case (meg) [Entry date 11/06/01] [3:99cv151]
12/04/01 97	Notice of appeal by plaintiff Michael Broudo in 3:99-cv-00151, plaintiff Roberta Speck in 3:99-cv-00151, from Dist. Court decision entered on 11/6/01. Receipt No/Amt of Fee: #077354, $105 [96-2]; t/w civil appeals docketing stmt and representation stmt (other plaintiffs listed in appeal not a party to this case) (aps) [Entry date 12/04/01] [3:99cv151]
1/14/02 —	Reporter's Transcript of proceedings for the following date(s) : 4/24/00 (Re: [97-1]) (andy) [Entry date 01/14/02]

1/14/02 —	Reporter's Transcript of proceedings for the following date(s): 3/26/01 (Re: [97-1]) (andy) [Entry date 01/14/02] [3:99cv151]
11/17/03 108	Certified copy of judgment from USCA reversing and remanding the Decision of the District Court re appeal [97-1] (apb) [Entry date 11/19/03] [3:99cv151]

APPENDIX C — SECOND CONSOLIDATED AMENDED COMPLAINT FOR VIOLATION OF THE SECURITIES EXCHANGE ACT OF 1934 DATED SEPTEMBER 23, 2000

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

Master File No. 99cv0151-L(NLS)

CLASS ACTION

In re DURA PHARMACEUTICALS, INC. SECURITIES LITIGATION

This Document Relates To:

ALL ACTIONS.

SECOND CONSOLIDATED AMENDED COMPLAINT FOR VIOLATION OF THE SECURITIES EXCHANGE ACT OF 1934

DEMAND FOR JURY TRIAL

THE FRAUDULENT SCHEME

1. Plaintiffs bring this action on behalf of purchasers of Dura Pharmaceuticals, Inc. ("Dura" or the "Company") securities between 4/15/97 and 2/24/98 (the "Class Period"). Dura became a publicly traded company in 1992, pursuing a business strategy of marketing niche pharmaceutical drugs. Typically Dura purchased the rights to market drugs developed by large pharmaceutical companies that were

approaching the end of their profitability to those companies. Dura did not have the resources or capability to develop drugs on its own. By 1995, however, it became obvious to Dura's management that, given the Company's size, it would be increasingly difficult to achieve continued revenue and EPS growth solely by acquiring marketing rights to niche drugs. Therefore, Dura insiders decided to embark on a risky and expensive diversification of its business, attempting to become a medical device development company and develop its own proprietary drug products.

2. In 1995, Dura began development of the Spiros drug delivery system for Albuterol ("Albuterol Spiros" or "Spiros drug delivery system"), a method of aerosolizing powders so that asthma medicines, including Albuterol, could be inhaled. According to Dura, its Spiros drug delivery system would be utilized first to deliver Albuterol and later other medications to persons with respiratory problems such as asthma. The system purportedly would have advantages over existing inhalers which were dependent upon the ability of the user to successfully coordinate the use of the inhaler and inhalation of the medication, something some persons with respiratory distress (such as children) had difficulty doing. The Spiros drug delivery system supposedly utilized a mechanically driven dosing mechanism that provided uniform dosing regardless of the ability of the patient to coordinate the operation of the inhaler.

3. The Spiros drug delivery system was a software-driven device with software programmed to turn on a motor that activated an impeller inside the device. The impeller extracted the Albuterol drug compound from the storage

cassette that fit inside the inhaler. The storage cassette contained 30 separate wells that each contained one dose of Albuterol dry power compound. Each time the inhaler opened and closed, one dose was released and the cassette advanced to the next well. With the software, the inhaler was programmed to allow the inhaler to dispense 1500 doses, which was considered the optimal dose lifetime for each inhaler.

4. The millions of dollars of necessary research and development costs associated with developing, testing and obtaining approval for the Spiros drug delivery system had to be immediately expensed as a charge against current earnings under GAAP. To avoid such a huge negative impact on its earnings, Dura's management created Spiros Development Corp. ("Spiros I") to incur Dura's costs of developing the Spiros drug delivery system. Dura performed the development work under contract to Spiros I and billed the expenses to Spiros I, plus a mark-up of 15% to 25%. Through this "off balance sheet" arrangement with Spiros I, Dura recorded revenue and profits on the "expenses" it incurred for research and development of the Spiros drug delivery system.

5. Although this arrangement protected Dura's positive financial results, it exacerbated the pressure on Dura's insiders to keep Dura's stock at high levels. Dura ultimately would have to use its stock to repurchase Spiros I when Spiros I ran out of funds. Spiros I had been funded in 12/95 through a $28 million private placement and $13 million from Dura. To induce investors to finance Spiros I, they were given warrants to purchase 2.2 million shares of Dura at $19.47 and Dura reserved the right to re-purchase Spiros I.

6. By 1997, the pressure on Dura's insiders to maintain a high stock price intensified. After reaching an all-time high of $47-7/8 on 12/31/96, Dura's stock declined sharply, falling to $27-7/8 on 4/14/97, due to concerns over the ability of Dura's existing drug lines to continue to drive Dura's EPS growth and the ability of Dura to successfully introduce the Spiros drug delivery system by late 1998 or early 1999. This decline created a dilemma for Dura's executives. The perception of weakness in Dura's drug sales was well-founded, as is described below.

7. More troubling for Dura executives were the significant problems plaguing the development of the Spiros drug delivery system since the fall of 1996. Because Dura executives desperately wanted to transform Dura to a drug device development company, they made the strategic decision to proceed to clinical trials in the fall of 1996 for the Spiros drug delivery system despite the fact that the system was merely a prototype that had not yet undergone sufficient development. Dura's executives, including defendants, put tremendous pressure on Dura's engineering department to develop a prototype. Although Dura's Product Development Department designed and manufactured the Spiros drug delivery system prototype and the Albuterol cassette very fast and this prototype performed well for a prototype, Dura executives decided to proceed to Phase III clinical trials even though the Spiros drug delivery system was not reliable and the Albuterol cassette system was not stable.

8. In fact, Dura's top executives ignored the recommendations of Dura's engineers to not proceed with

Phase III clinical trials and not proceed to file a New Drug Application ("NDA") until these problems were remedied. In 10/96, in an internal Dura engineering report, Robert Eisele, Dura's Vice President of Product Development, included a list of problems with the Spiros drug delivery system and the Albuterol cassette. This list of problems, five to six pages long, compiled by Eisele who was the lead project manager on Albuterol Spiros, detailed items Dura's engineers considered critical before an NDA could be submitted. The "Eisele List" was distributed to senior management at Dura during the weekly executive management meeting held every Monday from 8:00-10:00 a.m., and attended by defendant Cam Garner, Dura's President, Chief Executive and Operating Officer and Chairman, defendant James Newman, Dura's Chief Financial Officer and Senior Vice President of Finance and Administration, defendant Charles W. Prettyman, Senior Vice President of Development and Regulatory Affairs, defendant Walter Spath, Senior Vice President of Sales and Marketing, defendant Julia R. Brown, Senior Vice President of Business Development and Planning, defendant Mitchell Woodbury, Senior Vice President and General Counsel to Dura, David Kabakoff, Chief Executive Officer of Spiros Development Corp., Robert Schultz, Senior Vice President of Product Development, Robert Eisele, Malcolm Hill, Vice President of Clinical Development and Chet Damecki, Vice President of Operations.

9. One big problem with the Spiros drug delivery system set forth in the Eisele List was its reliability. Because it was a mere prototype, the delivery system was incapable of consistently delivering the required dose, was insufficiently

robust in that it could not withstand normal use conditions, and was subject to an unacceptable rate of failure. Another huge problem with the device set forth in the Eisele List was the stability of the Albuterol cassette system. In the cassette system, doses of Albuterol were stored in a vacuum-sealed foil pouch ready for insertion into the Spiros delivery device. After removal from the foil pouch, it was unknown how long Albuterol would remain chemically stable under realistic use conditions. For example, because a patient might use the device erratically or under varying temperature and humidity conditions, the Albuterol would have to remain stable.

10. Because Albuterol stability was so important, before Phase III clinical trials began, Dura devised in-house testing. Respirable dose amounts of Albuterol were subject to aging experiments at certain temperatures and humidity levels – 25 degrees centigrade and 75 percent relative humidity – for fixed periods of time according to industry testing procedures and FDA requirements. Following the temperature – humidity aging process, the sample dose was dispensed from the Spiros delivery device into a filter designed to simulate a human lung. FDA guidelines set forth standards regarding acceptable levels of reduced drug efficacy and changes in particle size not to exceed 10% in the specified time frame. Dura's in-house aging tests showed unacceptable levels of reduced efficacy. Basically, as the drug aged at fixed temperatures and humidity, the Albuterol particles clumped together allowing less to be absorbed into a patient's lungs. Senior management was kept apprised that Albuterol failed Dura's in-house aging tests via chemical stability test results and analytical reports that were circulated during weekly product development meetings. Albuterol chemical stability issues

were also described in detail in minutes generated from the product development meetings and circulated to senior management.

11. By the time Dura commenced Phase III clinical trials for the Spiros delivery device with Albuterol, defendants were aware that the device had serious reliability and Albuterol stability problems that Dura's own engineering department recommended be remedied before commencing clinical trials. Defendants, however, who had predominately sales and marketing and not scientific backgrounds, decided to pursue Phase III clinical trials, over the objections of Dura's own engineers, without an adequate scientific basis because they were desperate to transform Dura into a drug development company.

12. Not surprisingly, serious reliability problems manifested themselves during the Phase III clinical trials. To ensure the Spiros device's reliability, during clinical trials the Spiros device was subjected to "benign abuse conditions" designed to test the device's reliability under ordinary types of abuse conditions. One example is dropping the device from various heights. During clinical trials, Dura experienced an over 30% failure rate of the devices. Because of this high failure rate, Dura experienced an extremely high early return rate, which measures the number of inhalers removed from the clinical studies before the 1500 dose lifetime marker as compared to the total number of inhalers dispensed for clinical trials. Dura experienced an early return rate exceeding 30% due to the inhaler's unreliability. This early return rate experienced during clinical trials was much higher than the FDA would find acceptable. In fact, during the development

of medical devices, the industry standard is to try to achieve an early return rate of 1% or less to avoid incurring expensive repairs once the device is on the open market.

13. The unacceptably high early return rate Dura experienced during the first study conducted in Phase III clinical trials (drug efficacy) was caused by reliability problems that kept the inhaler from functioning. The battery-wires that powered the inhaler kept disconnecting from the battery because of faulty welds connecting the battery contacts to the wiring. Additionally, the routing and gauging of certain wires running from the battery to the inhaler's internal motor caused the inhaler to malfunction so that it would not open and close each time when it was dispensing a dose of Albuterol. When these failures occurred before the inhaler reached the 1500 dose lifetime mark, an "end-of-life" response was triggered in the inhaler and it just stopped functioning. When the inhaler was functioning properly and ready to dispense a dose of Albuterol, a green light indicator was activated. Once the end-of-life response was triggered, or if the 1500 dose lifetime was reached, a red-light indicator was activated. Once the red light was on, the inhaler stopped working altogether.

14. As a result of the inhaler's reliability problems during Phase III clinical trials, Dura began making modifications to the inhalers actually being used in the ongoing clinical trials to improve reliability. Dura included multiple versions of the inhaler in the Phase III clinical trials. The modifications made to the inhaler during trials included using different shaped battery contacts that were welded to the battery to better secure the battery wires, re-routing certain

wiring and using stronger gauge wire. Dura also modified the inhaler's lid to make it easier to see the remaining doses of Albuterol and ribbing was added to the outside of the device to make it easier to hold. Dura kept very careful track of the different versions of the inhaler used in clinical trials. The various configurations of the inhaler were given different "Rev" designations. For example, the configuration of the device first used in clinical trials was designated Rev D, while Rev G was a modified version added halfway through clinical trials to address reliability concerns. Rev H and Rev J were designations given to still later versions of the inhaler.

15. All modifications were well documented within the clinical trial results and reliability reports and each test run on each configurations was analyzed in a separate report. In each of the reports, the configuration number and the test type were referenced in the title of the report such as Rev G vibration or Rev G impeller test. More importantly, senior management at Dura, including defendant Prettyman as Senior Vice President of Regulatory Affairs, had to sign off on proposed modifications before they could be made. Other employees within the Regulatory Affairs department, Kathleen Heffernan, Director of Regulatory Affairs, and Darlene Rosario, Regulatory Affairs Manager, were also intimately familiar with the modifications being made to the inhaler and involved in approving the modifications.

16. Senior management at Dura, including defendants, were kept constantly informed of the problems affecting the inhaler's reliability via product reports prepared by Mike Ligotke, the Senior Product Engineer for the Spiros device and Linda Gieschen, the Spiros Project Leader. These same

reports also constantly informed senior management of the different configurations of the inhaler, the different tests being performed and the results of those tests. These reports were prepared for and circulated in advance of and during weekly research and development meetings attended by senior management. Research and development meeting minutes, that also detailed the inhaler's reliability problems and the different versions of the inhaler, were prepared and circulated to senior management following the meetings.

17. Making changes to a device in the middle of clinical trials rendered the trials invalid because the modifications cast doubt on whether the product tested would, in fact, be the final product described in the NDA. Senior executives at Dura were so concerned about the inhaler's reliability problems and the mid-clinical-trial modifications that were made to the device, that the decision was made to contract with an outside testing facility, El Segundo, California-based Wyle Labs, to conduct highly accelerated life tests ("HALT") on the device. HALT are extreme condition tests designed to identify potential operational failures in a device. Dura contracted with Wyle Labs to conduct these tests while Phase III clinical trials were still ongoing. Ed Dusel, Senior Engineering Development Manager, managed the Wyle Lab testing and Mike Ligotke, Senior Project Manager, analyzed the test results. Dura gave Wyle Labs inhaler configurations Revs D, G, H, and J of the device. Dura used the HALT results from Wyle Labs in an 9/98 amendment to Dura's NDA to try to demonstrate that the different inhaler configurations tested in Phase III clinical trials as well as the concurrent HALT resulted in progressively improved operational reliability.

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18. At the same time, Phase III clinical trials were being completed, defendants were already taking steps to complete a major debt offering in the next several months for Dura to obtain desperately needed working capital to acquire additional products. They also knew that Spiros I would exhaust its financial resources during 1997, and Dura would have to exercise its option to repurchase Spiros I and finance a new follow-on Spiros Development Corp. II entity ("Spiros II") to continue to pay for the ongoing development of Albuterol Spiros.

19. In addition, the value of Dura's insiders' existing stock options to purchase thousands of shares of Dura stock at $29.63-$37.63 per share had been completely wiped out by the early 1997 stock decline, while the value of their other lower priced options had been severely diminished. Finally, the 1997 cash bonuses of Dura's top executives – which could amount to 100% of their base salaries – were dependent upon Dura meeting internally set 1997 EPS targets and Dura's stock price performance during 1997.

20. For all of these reasons, it was imperative to Dura's insiders that they drive Dura's stock higher during 1997 to enable Dura to accomplish a huge debt offering to raise desperately needed capital, to exercise its option to purchase Spiros I stock by issuing as few Dura shares as possible, to successfully complete a public offering of Spiros II securities, to restore the value of their stock options so that they could unload hundreds of thousands of shares of the Dura stock they owned, pocketing millions in insider-trading proceeds before the stock collapsed, and to achieve large cash bonuses based on Dura's 1997 EPS and a strong 1997 stock performance.

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21. To accomplish their scheme, defendants commenced in 4/97 a concerted campaign to falsely persuade investors that Dura's sales were increasing and that Dura was successfully completing the development and clinical trials of the Spiros drug delivery system. To ensure their personal gain, the Individual Defendants in 4/97 repriced hundreds of thousands of their $37.63 per share options lower – to just $25 per share. Then on 4/15/97, Dura issued a press release announcing better-than-expected Q1 1997 results, representing that "Dura continues to execute its strategy of developing its proprietary Spiros dry powder drug delivery technology" and has completed the design of its Albuterol Spiros drug system and the patient dosing studies necessary for filing an NDA with the FDA. The 4/15/97 press release also represented that Dura was making strong progress selling Ceclor CD and that the drug was being well received by prescribing physicians. In response to these positive representations and Dura's strong Q1 financial results, Dura's stock soared from $27-7/8 on 4/14/97 to $34 on 4/15/97. Following the release of Dura's Q1 1997 results, defendants went to great lengths to convince securities analysts, during conference calls and in one-on-one sessions, that the Spiros delivery device development was on track and Dura was executing its strategy to transform itself into a drug development company. Defendants interactions with securities analysts had their desired effect as one analyst noted: "Without Spiros, Dura would be strictly a high-growth specialty marketing company, acting as a consolidator of niche respiratory product lines."

22. In fact, however, despite their public praise of the Spiros technology, defendants knew from the clinical trial

data that the Spiros drug delivery system suffered from serious reliability problems forcing Dura to remove over 30% of the inhalers from clinical trials and the Albuterol cassette suffered from serious stability problems, all of which would prevent approval of Dura's NDA. Despite that Dura modified the device, conducted in-house, stability testing showing that Albuterol was not stable and even contracted an outside firm to test the device, defendants assured investors that the device had successfully completed clinical trials, that the Company would file the NDA later in 1997 and commence marketing the device in 1998.

23. In addition to concealing these problems, defendants also concealed a pre-NDA filing meeting Dura conducted with the FDA in 5/97. This meeting, which took place in the FDA's offices in the Washington, D.C. area, was attended by defendants Garner and Prettyman and Kathleen Heffernan, David Kabakoff and Chet Damecki. During that meeting, the FDA raised concerns about how mechanically reliable the doser was for consistently delivering Albuterol to the user's lungs in the right amount or at all. The FDA also questioned whether and how long Albuterol contained in the cassette would remain chemically stable after removal from the foil pouch. By the time the pre-NDA filing meeting occurred with the FDA, Dura had completed clinical trials and 95% of the data from the trials had been received by Dura.

24. Despite their knowledge that Dura's engineers wanted to do further development of the Spiros device, that the Eisele List identified the inhaler's reliability and Albuterol's stability as necessary items to be fixed before an

NDA could be successfully submitted, that Albuterol had in fact failed Dura's in-house temperature-humidity age testing, that Dura had done nothing to remedy Albuterol's stability problems, that serious reliability problems caused over 30% of the Spiros inhalers to fail during clinical trials, that Dura had retained Wyle Labs to conduct HALT and that Dura executives, including defendants Garner and Prettyman, attended the pre-filing meeting with the FDA which raised the same concerns identified by Dura's own engineers in the Eisele List and for which Dura had no satisfactory answer, defendants embarked on a massive bailout of Dura stock selling 188,626 shares for over $7.3 million between 5/12/97 and 7/22/97.

25. Defendants compounded their wrongdoing later in 1997 with additional, highly suspicious insider trading of Dura stock. Because the Spiros device was so unreliable and Dura had been forced to modify the device and could not adequately demonstrate the stability of Albuterol, certain Dura insiders were against filing the NDA. In fact, in late October or early November 1997, a meeting was held to discuss the NDA filing. Defendants Garner and Prettyman along with Kabakoff and Damecki attended the meeting during which Prettyman made it very clear that he did not want to file the NDA, for which his department, Regulatory Affairs, was responsible. Prettyman was against filing the NDA because based on his prior experience – Prettyman worked for the FDA for over ten years prior to working for Dura – he knew the NDA would not be approved by the FDA. Despite this, defendant Garner and Kabakoff forced Prettyman to file the NDA. Shortly after the NDA was filed, Dura and Spiros II raised $88 million to fund Spiros II.

Despite his knowledge that the NDA would not pass, defendant Prettyman sold 15,000 shares of Dura stock on 11/5/97 for proceeds exceeding $728,000. Other defendants similarly engaged in suspicious insider trading concurrent with the filing of the doomed NDA as defendants collectively dumped 197,607 shares for proceeds exceeding $9.2 million between 11/3/97 and 1/6/98.

26. In addition to concealing the problems plaguing the Spiros drug delivery system development, defendants also made false statements regarding strong sales of Dura's drugs, including Ceclor CD, Keftab, Nasarel/Nasalide, Rondec and Dura-Vent. Defendants falsely represented that certain of Dura's recently acquired niche pharmaceutical products were selling well to convince the securities markets that it was achieving strong revenues and earnings even as it completed development of the Spiros drug delivery system. Dura had acquired two prescription antibiotics, Ceclor CD and Keftab, on 8/22/96. Defendant Garner stated: "Keftab and Ceclor CD are ideally suited for Dura as they should provide strong revenue and earnings growth and support the expansion of our sales force to position Dura for an effective launch of our Spiros products."

27. Ceclor CD would become Dura's largest-selling product, however its sales were not growing, but were flat or declining. Ceclor CD is a slow-release form of Ceclor, a second generation cephalosporin generically known as cefaclor. It was developed by Lilly in the 1980's, which later sold it to Dura. As it has significant side effects, including serum-sickness-like reactions and shock, its use has decreased in recent years as more powerful antibiotics with less significant side effects have been developed.

28. Also hurting Ceclor CD sales during the Class Period was the fact that the drug was not listed on most managed-care formularies, and therefore would not be covered by most managed-care insurance. As a result of these factors, Ceclor CD sales began to drop around March or April 1997, and significantly worsened during the summer months. Actual sales were 25-40% below Dura's internal projections. To bolster their representations of strong Ceclor CD sales, Dura reported market share by comparing Ceclor CD not to the entire class of respiratory antibiotics, but only to sales of Lilly's generic Ceclor product. Defendants therefore knew that the market share increases reported during the Class Period were misleading when made and falsely suggested that Ceclor CD sales were strong and expanding. If Dura had properly compared its sales of Ceclor CD to all other drugs in the same class, namely, those drugs used to cure respiratory infections, sales of Ceclor CD would not have reflected any market share growth during the Class Period.

29. Knowing that Dura was experiencing a decline in the demand for its drug lines, including Ceclor CD, Dura undertook a scheme to artificially inflate its revenues and earnings by shipping at the ends of quarters excess amounts of product to wholesalers. Defendants accomplished this in varying ways. The Director of National Accounts, Doug Weiherer, pressured his subordinates to push extra product into the pharmacy chains in order to increase EPS. In addition, defendant Spath or other upper management would contact the Company's larger wholesalers, such as McKesson and Berger Brunswig, to get an "additional buy" from them at quarter ends. The wholesalers took more product than they had orders for because Dura would reduce two or three

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"points" from the wholesale purchase price and extend the payment date to give them time to move the product. As wholesalers operate on a narrow profit margin, these price reductions could increase their margins 30-50%. In 12/97, Dura offered a 5% price reduction to wholesalers on purchases of Ceclor CD.

30. Garner himself had to approve price reductions to wholesalers, so he knew in each instance when these practices occurred. As a result, Dura product inventories in the distribution channel were greatly in excess of the normal one- month supply. As a result of these practices, the success of Dura's products was misrepresented and its sales were artificially inflated. Defendants knew that, as a result of "borrowing" millions of dollars of sales of Ceclor CD and other products from future periods, Dura's sales would eventually fall sharply once this practice was stopped. By the spring of 1998, defendants admitted to securities analysts that Dura's wholesale channels were clogged with as much as a five-month inventory of its products.

31. In addition to false statements about Ceclor CD, defendants also falsely portrayed that the Company was experiencing strong sales of its Keftab, Rondec, Dura-Vent and Nasalide products. In fact, all of these products were experiencing declining sales during the Class Period. For Rondec, defendants failed to disclose that Dura would be unable to recoup its investment in that drug. Dura falsified and inflated its Q1, Q2, Q3 and Q4 1997 EPS by failing to take required write-downs on the carrying value of its investment in the Rondec product line, which were required because the sales of that product line had so declined and were so poor that Dura could not recover its investment in Rondec.

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32. On 2/24/98, after the close of trading, Dura shocked the market by revealing that it expected much lower than forecast 1998 revenues and 1998 EPS – at least $.50-$.55 lower than the $1.40-$1.45 being forecast – due to, *inter alia*, slower Ceclor CD and Nasarel/Nasalide sales and the immediate need to vastly increase the size of Dura's sales force from 270 to over 450 to try to boost sales of existing products. Investors were stunned. Even though the Dow Jones average went up 87.7 points on 2/25/98, Dura's stock collapsed from $39-1/8 on 2/24 to $20-3/4 on 2/25 – an 18-3/8 point, 47% one-day decline on incredible volume of 32 million shares. Analysts were also furious over having been lied to. Alex. Brown analyst Ryan wrote:

> Management credibility has been severely damaged by this announcement, particularly in light of recent investor conference presentations exuding confidence on the Company's fundamentals. . . .
>
> * * *
>
> Our confidence in management and their credibility with us has been greatly diminished. As recently as one month ago, we reviewed our model with the Company line by line and were guided to higher Ceclor CD estimates.

33. As no great surprise to Dura insiders, Dura subsequently revealed that the FDA had found that Albuterol Spiros was not approvable due to electro-mechanical reliability issues and chemistry, manufacturing and control

concerns, but claimed that the FDA "raised no issues on the clinical data with the inhaler filed in the NDA demonstrating therapeutic comparability of Albuterol Spiros™ with Ventolin® (albuterol) MDI using standard lung function measures." Just a few days later, however, the FDA issued a "notice of violation" to Dura stating that Dura's press release "'misleadingly minimizes the fact that Dura must conduct a completely new clinical data [study],'" and demanded that Dura immediately cease distribution of materials containing its previous claims. Dura immediately removed the offending press release from its Web site and has admitted that Albuterol Spiros will be delayed by at least a year as completely new Phase III clinical trials are required. The FDA rejected the NDA for Albuterol Spiros because Dura changed the device during clinical trials, had not shown that the device was reliable, and could not demonstrate Albuterol's device based on the same issues stability. In other words, the FDA rejected the Albuterol Spiros device based on the same issues delineated in the Eisele List in 10/96.

34. Dura's business performed miserably during 1998. Sales of Ceclor CD fell sharply to only about $30 million as Dura admitted the distribution channel was clogged with many months of excess inventory. Dura also revealed that sales of Keftab, Nasalide and Dura-Vent were very disappointing and that sales of its Rondec product had plummeted so much that by mid-1998 Dura had to create DJ Pharma, Inc. to take these drugs off its hands so it could avoid reporting large losses for those products. Dura also admitted that its sales force was inadequate, which contributed to Dura's poor sales. By 9/98, forecasts of Dura's 1998 and 1999 EPS were cut to $.53 and $.71 – large declines

from Dura's 1997 EPS of $.99. Dura's CEO admitted that there was excessive inventory of its top-selling antibiotic Ceclor CD to start the year, which took at least five months to work down.

35. Later still, Dura announced that it would abandon its efforts to seek FDA approval of the Spiros delivery device for use with Albuterol. Dura was never able to solve the Albuterol stability issues that were revealed during Dura's in-house stability testing conducted in 1996 before clinical trials even began.

36. The price action of Dura stock from its 1992 IPO through 12/98 is set forth below:

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Dura Pharmaceuticals, Inc.
February 7, 1992 - January 8, 1999
Daily Stock Prices

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37. Public investors, who purchased Dura stock at prices inflated by the false representations about the successful development of Albuterol Spiros, continuing strong sales of Dura's non-proprietary products, and very strong sales of Ceclor CD, and who thus paid as high as $53 for Dura's stock during the Class Period, have suffered millions in damages. Dura and Dura's insiders who knew the truth fared much better. Before the startling truth was revealed and Dura's stock price collapsed, Dura raised over $375 million in desperately needed new capital from note purchasers, and in total the Individual Defendants unloaded 386,233 shares of their Dura stock at artificially inflated prices as high as $49.31, pocketing over $16.6 million in illegal insider-trading proceeds. This illegal insider selling is summarized below:

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Dura Pharmaceuticals, Inc.

Class Period: April 15, 1997 - February 24, 1998

Insider	Class Period Sales/ Distributions	Sales Proceeds	Percent of Stock Sold (1)	Percent of Total Holdings Sold (2)
Brown, Julia R	39,383	$1,583,590	100%	36%
Cook, Joseph C. Jr.	40,000	$1,780,950	43%	29%
Garner, Cam L.	154,623	$6,456,801	67%	62%
Newman, James W.	52,227	$2,390,417	78%	34%
Prettyman, Charles W.	15,000	$728,100	100%	46%
Spath, Walter F.	50,000	$2,076,500	100%	32%
Woodbury, Mitchell	35,000	$1,603,280	100%	31%
Total:	386,233	$16,619,638		

(1) Includes common stock and options exercised and sold during the Class Period.

(2) Includes common stock, options and warrants exercisable.

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38. Dura's quarterly financial performance is set forth below:

Dura
Quarterly Results
(in thousands, except EPS)

	1996				
	03/31	06/30	09/30	12/31	Year
Revenues	$18,590	$18,800	$25,920	$40,810	$104,210
Net income	$ 4,060	$ 4,610	$ 5,810	$ 9,860	$ 24,340
EPS	$.13	$.14	$.15	$.24	$.68

	1997				
	03/31	06/30	09/30	12/31*	Year*
Revenues	$40,890	$43,630	$43,340	$53,460	$181,320
Net income	$ 8,790	$ 9,280	$11,200	$18,000	$ 47,400
EPS	$.19	$.20	$.24	$.37	$.99

	1998				
	03/31	06/30	09/30	12/31	Year
Revenues	$48,770	$51,940	$43,360	$55,080	$199,152
Net income (Loss)	$ 7,160	$ 8,180	$ 2,420	($15,030)	$ 2,733
EPS	$.16	$.18	$.05	($0.33)	$0.06

* Excludes one-time charges of $137.6 million in Q4 1997 related to the Spiros development program. Including the charges, Dura suffered a loss of $2.57 and $1.93 for the quarter and year ended 12/31/97.

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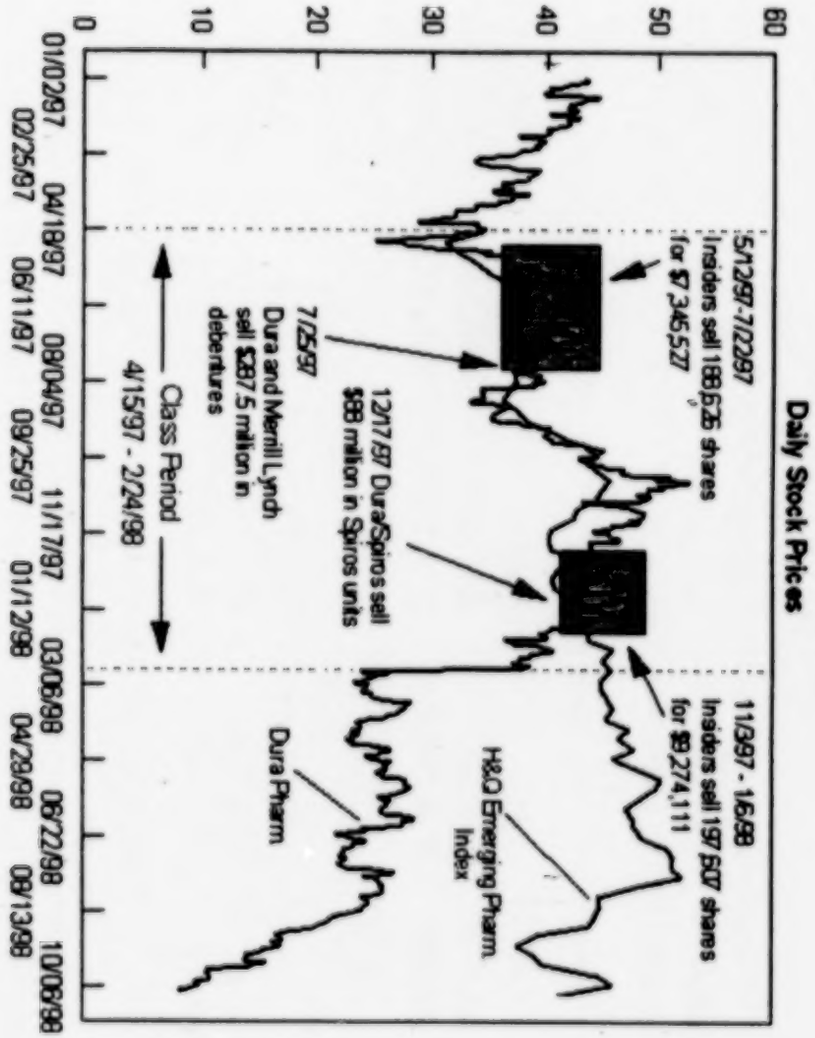
39. The chart below shows how the defendants took advantage of their false and misleading statements and Dura's artificially inflated stock price and that, when compared to an index of similar stocks, Dura's stock was inflated and declined due to company-specific events and not market or industry forces:



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JURISDICTION AND VENUE

40. The claims asserted herein arise under §§10(b) and 20(a) of the Securities Exchange Act of 1934 ("1934 Act") and Rule 10b-5. Jurisdiction is conferred by §27 of the 1934 Act. Venue is proper pursuant to §27 of the 1934 Act.

THE PARTIES

Lead Plaintiffs

41. Michael Broudo purchased 100 shares of Dura common stock on 2/24/98 at $38.94 per share and 2,000 shares on 2/24/98 at $38.88 per share, and was damaged thereby.

42. Baldev S. Gill purchased 4,000 shares of Dura common stock on 2/9/98 at $39.88 per share; 2,000 shares on 2/13/98 at $38.72 per share; 1,000 shares on 2/17/98 at $37.64 per share; 2,000 shares on 2/19/98 at $37.53 per share; and 3,000 shares on 2/20/98 at $36.96 per share, and was damaged thereby.

43. Larry Morgan IRA purchased 1,290 shares of Dura common stock on 1/28/98 at $39.13 per share, and was damaged thereby.

44. Leonid S. Shvartsman (for G&S Partnership) purchased 2,000 shares of Dura common stock on 2/17/98 at $38.25 per share, and was damaged thereby.

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45. Neil Siskind purchased 15 of Dura's Convertible Subordinated Notes on 7/30/98 at $1,025.00 per note, and was damaged thereby.

46. Roberta Speck purchased 50 of Dura's Convertible Subordinated Notes on 7/30/97 at $1,022.50 per note, and was damaged thereby.

47. Brent Vogt purchased 500 shares of Dura common stock on 6/15/97 at $39.58 per share; 100 shares on 7/29/97 at $37.32 per share; 500 shares on 9/2/97 at $36.35 per share; 500 shares on 9/17/97 at $41.60 per share; and 500 shares on 10/29/97 at $45.35 per share, and was damaged thereby.

Defendants

48. Dura Pharmaceuticals, Inc. ("Dura") is a San Diego-based developer and marketer of prescription pharmaceutical products for the treatment of allergies, asthma and related respiratory conditions. Dura pursues a two-step business strategy: (1) licensing, acquiring and developing late stage pharmaceuticals for marketing to high-prescribing respiratory physicians, and (2) developing Spiros, a proprietary dry powder drug delivery system for use with respiratory and non-respiratory drugs. Dura's common stock trades in an efficient market on the NASDAQ National Market System. As of the beginning of the Class Period, Dura's products included:

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Allergy, Cough and Cold

Dura-Vent®	–	Tablets
Dura-Vent/DA®	–	Tablets
Rondec®	–	Oral drops
Rondec®	–	Syrup
Rondec®	–	TR tablet
Rondec®	–	Tablet
Rondec®	–	DM oral drops
Rondec®	–	DM syrup
Rondec®	–	Chewable tablets

Antibiotics

Keftab®	–	Tablets
Ceclor®	–	CD tablets

49. (a) Cam L. Garner ("Garner") was President, Chief Executive and Operating Officer and Chairman of Dura during the Class Period. He sold 154,623 shares of his Dura stock based on inside information, pocketing over $6.4 million in illegal insider-trading proceeds – 67% of the Dura stock he actually owned.

(b) James W. Newman ("Newman") was Senior VP-Finance & Administration and CFO of Dura during the Class Period. He sold 52,227 shares of his Dura stock based on inside information, pocketing over $2.3 million in illegal insider-trading proceeds – 78% of the Dura stock he actually owned.

(c) Charles W. Prettyman ("Prettyman") was Senior VP-Development and Regulatory Affairs of Dura during the Class Period. He sold 15,000 shares of his Dura stock based

on inside information, pocketing over $728,000 in illegal insider-trading proceeds – 100% of the Dura stock he actually owned.

(d) Walter F. Spath ("Spath") was Senior VP-Sales & Marketing of Dura during the Class Period. He sold 50,000 shares of his Dura stock based on inside information, pocketing over $2 million in illegal-insider trading proceeds – 100% of the Dura stock he actually owned.

(e) Mitchell R. Woodbury ("Woodbury") was SVP/ General Counsel of Dura during the Class Period. He sold 35,000 shares of his Dura stock based on inside information, pocketing over $1.6 million in illegal insider-trading proceeds – 100% of the Dura stock he actually owned.

(f) Julia R. Brown ("Brown") was Senior VP-Business Development and Planning of Dura during the Class Period. She sold 39,383 shares of her Dura stock based on inside information, pocketing over $1.5 million in illegal insider-trading proceeds – 100% of the Dura stock she actually owned.

(g) Joseph C. Cook, Jr. ("Cook") was a director of Dura during the Class Period. He sold 40,000 shares of his Dura stock based on inside information, pocketing over $1.7 million in illegal insider-trading proceeds – 43% of the Dura stock he actually owned.

(h) The defendants named in ¶49(a)-(g) are the "Individual Defendants," and are each liable for the false statements pleaded in ¶¶51, 55-56, 74, 111 and 123, as they were "group-published" information.

50. Garner, Newman and Spath, by reason of their positions with Dura, were controlling persons of Dura and the other Individual Defendants. They are therefore liable under §20(a) of the 1934 Act.

FALSE OR MISLEADING STATEMENTS

51. On or about 4/15/97, in its 1996 Annual Report, Dura stated, among other things, that:

> Dura is able to access about 52% of total respiratory prescriptions written with its highly focused, yet relatively small, sales and marketing organization. The Company's goal is to increase its sales organization to approximately 280 by year-end 1997.
>
> * * *
>
> Dura's highly motivated sales people have proven sales records. . . . Their concentration on respiratory disease, coupled with extensive product and sales training, differentiates them from their competition.
>
> * * *
>
> Dura's highly trained sales representatives have established credibility.... Due to the concentrated nature of the Company's target market, Dura can achieve significant penetration with a relatively small sales force.

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52. At all times during the Class Period, Dura knew that the statements about the quality of its sales force were false when made. In reality, Dura's sales force was inefficient, underpaid, and suffered from an extremely high rate of turnover. Compensation packages for Dura sales representatives were not competitive with the rest of the pharmaceutical industry. In early 1997, Dura attempted to reduce its salesperson turnover rate by increasing the base salary of its sales force. However, at the same time, Dura decreased commissions paid to salespersons, thereby failing to solve its turnover problem. Dura failed to distribute sales revenue figures of any kind to the sales force, thereby making them ill-equipped to deal with changes in the market. Dura frequently ignored its stated requirement that sales applicants have a minimum of two years of prior sales experience, thereby reducing the collective quality of the sales force.

53. Additionally, Dura's sales force was hampered by a non-operational software and sales force hand-held computer system during the Class Period. Dura had contracted with Walsh International, Inc. to install the Precise System by 9/96. By 4/97, however, the system had just been installed and Dura had identified some 24 malfunctions that were severely hampering its sales force's performance. By 12/97, the malfunctions had worsened to the point where Dura was incapable of preparing necessary quarterly inventory reports or accurate FDA reporting.

54. Defendant Woodbury's knowledge of these problems plaguing Dura's inventory systems are demonstrated by the letter he sent to and the lawsuit filed against Walsh International in 4/98. *See* Exhibit A hereto.

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55. With respect to Dura's Spiros drug delivery technology, the 1996 Annual Report stated:

> The Spiros family of drug delivery systems advances the promise of pulmonary drug delivery by addressing the weaknesses of existing inhalation delivery systems. In contrast to existing systems, including nebulizers, metered dose inhalers (MDIs) and traditional dry powder inhalers (DPIs), Dura's Spiros system is designed to be easy for patients to use, is breath-actuated and free of CFC propellants. In addition, each Spiros system is compact, durable and reusable.
>
> Most important, however, is the fact that Spiros is designed to be "flow rate independent," which means it can deliver a consistent dose of a drug relatively independent of a patient's ability to inhale forcefully. It also means most patients receive an adequate dose with minimal inhalation effort – a key benefit to a patient who is suffering an asthma attack. The greater ease-of-use and convenience of Spiros, combined with its effectiveness in delivering the intended dose to the patient, should translate into more regular and efficient use. . . .
>
> CORE COMPETENCIES IN PLACE
>
> Dura's current Spiros development capabilities include a newly constructed manufacturing facility designed to meet rigid

GMP requirements, and dedicated to the production of dry powder formulations of various pharmaceutical compounds. The facility has been licensed by the State of California and clinical trial materials are now being manufactured on-site. As the Spiros program advances, the facility will have the capacity to produce commercial-scale quantities of material.

* * *

Dura's expert scientific team has developed precision technology for the formulation, blending, milling and filing of a variety of drugs for delivery in Spiros.

56. Also, on 4/15/97, Dura announced in a press release better-than-expected Q1 1997 results:

> Dura . . . announced that revenues and net income for the first quarter more than doubled over the same period last year. Revenues for the quarter totaled $40.9 million and net income was $8.8 million. . . . [EPS] were $0.19, a 73% increase from $0.11 in first quarter 1996. . . .
>
> "We are very pleased with first quarter results," said Cam Garner, Dura's Chairman, President and Chief Executive Officer, "and we are happy with the strong progress made in selling our new respiratory antibiotic, Ceclor® CD." In the first quarter, Dura doubled the Ceclor® CD

> share of cefaclor weekly new prescriptions over fourth quarter 1996 to 15%, up from 7.5% at year end. Commenting on this increase, Garner noted "Since the product launch just 20 weeks ago, our sales representatives have been successfully delivering the message to high prescribing physicians of patient compliance advantages of Ceclor® CD over Ceclor® in the treatment of bronchitis.

* * *

> Dura continues to execute its strategy of developing its proprietary Spiros™ dry powder drug delivery technology. . . ."Patient dosing was completed for clinical trials needed for NDA (new drug application) submission of Spiros™ albuterol, and U.S. clinical trials for Spiros™ beclomethasone were initiated." . . .
>
> "The year is off to a great start," commented Garner.

57. Dura's stock soared from $27-7/8 on 4/14/97 to $34 on 4/15/97, as a result of these announcements.

58. Each of the statements made on 4/15/97 regarding Dura's sales and business performance were false or misleading when issued. The true but concealed facts were:

(a) Sales of Dura's major drug products were flat or declining, especially Ceclor CD, whose sales levels were dropping throughout the Class Period;

(b) Dura was encountering serious and persistent problems with its sales force which was inadequately trained, was suffering from very high turnover and was insufficient in number and skill to adequately market Dura's drug products, including Ceclor CD, Keftab and Rondec;

(c) Dura was experiencing serious problems with its inventory and sales reporting system as a new system that was supposed to be fully operational by the fall of 1996 had not yet been installed;

(d) In order to cover up the sales shortfalls described above, Dura was engaging in a subterfuge to artificially inflate its revenues and EPS by shipping excessive amounts of Ceclor CD and other products to wholesalers, who were enticed to take the product by price discounts, extended payment terms and/or other incentives. As a result, Dura's Ceclor CD and other product inventories in the distribution channel were greatly in excess of the normal one-month supply. As a result of this practice, Dura's Ceclor CD sales were artificially inflated and Dura's insiders knew that as a result of "borrowing" millions of dollars of sales of Ceclor CD from future periods, Dura's sales of Ceclor CD would fall sharply once this practice stopped;

(e) Dura's Rondec and Dura-Vent product lines were suffering very poor sales, declining so rapidly and performing so poorly that Dura would not be able to recover its remaining investment in Rondec from those sales; and

(f) Dura had falsified and artificially inflated its Q1 1997 EPS by failing to take required write-downs on the

carrying value of its investment in the Rondec product line, which were required because the sales of that product line had so declined and were so poor that Dura could not recover its remaining investment in Rondec

59. Garner, Prettyman, Spath, Woodbury and Brown had knowledge of the false and misleading statements regarding Dura's Q1 1997 results as they were the top executives of Dura. They ran Dura as "hands-on" managers, dealing with the important issues facing Dura's business, such as sales of its Ceclor CD/Keftab, Rondec, Nasalide/Nasarel and Dura-Vent products, the development of its new Albuterol Spiros product, the issuing of Dura's SEC filings, press releases and financial statements, Dura's investment in Rondec and the development and expansion of its sales force. Garner, Prettyman, Spath, Woodbury and Brown each attended the weekly executive management meetings from 8:00 to 10:00 a.m. every Monday.

60. Because increased sales of Ceclor CD/Keftab, Rondec, Nasalide/Nasarel and Dura-Vent products, the successful development of and substantial sales of Dura's Albuterol Spiros product, and the continuing sales of Dura's core products were indispensable elements to Dura meeting its internally budgeted and publicly disseminated 1998 and 1999 revenue and EPS forecasts, defendants constantly monitored each of these key factors affecting Dura's business.

61. Each of the Individual Defendants, because of their top executive positions with Dura and involvement in the day-to-day management of its business, actually knew from internal corporate documents and conversations with other

corporate officers and employees and their attendance at management and Board meetings, the adverse non-public information about the poor sales of Dura's Ceclor CD/Keftab, Rondec, Nasalide/Nasarel and Dura-Vent products, the serious problems in the development of Dura's Spiros drug development system, Dura's falsification of its reported Q1 1997 EPS, and Dura's deteriorating revenue and EPS prospects.

62. The Dura Defendants closely monitored the performance of Dura's business via internal reports generated on a daily, weekly and monthly basis. Among the specialized reports prepared were drug-by-drug sales volume summaries, year-over-year sales volume comparisons of each Dura product, sales volume comparisons of Dura drugs to competitor drugs, sales revenue reports, and daily, weekly and monthly reports on prescription volumes, competitor prescription volumes, and market share. On a monthly basis, Dura's Information Technology department, after receiving information from IMS, a service that tracks prescription drug sales, would prepare reports comparing actual versus planned sales of Dura's drug products. Through such reports, which were prepared for and disseminated by defendant Spath, defendants were kept apprised of Dura's drug sales and knew that such sales were below plan and insufficient for Dura to achieve continued growth in sales and earnings.

63. The monthly sales reports showed, for example, that Ceclor CD sales began dropping around March-April 1997, and significantly worsened during the summer of 1997. These reports showed that sales were 25-40% below internal projections at that time. Monthly sales reports showed that

Ceclor CD sales dropped from 47,288 in 3/97 to 39,808 in 5/97 to 24,797 in 7/97.

64. The Finance Department also distributed monthly financial reports comparing Dura's actual financial results to projected results. Thus, each Dura Defendant was apprised of the sales of every Dura product so that they knew where Dura stood in terms of the sale of and demand for its products as well as Dura's actual results compared to plan. Thus, the Dura Defendants were constantly aware of the prescription rate for its products and knew that excess inventory was building up with distributors and that Dura was not recouping its investments in certain drugs.

65. Dura recognized revenue on the sale of a product when it shipped the product to drug wholesalers. These drug wholesalers in turn would resell the drug to pharmacies, drug chains or even individual physicians. Dura did not publicly disclose to analysts or investors sales of each of its various drug products, *i.e.*, shipments to wholesalers. Thus, analysts and investors were completely dependent upon what Dura told them regarding sales of these products, as shipment-to-wholesaler data is not publicly available. While the number of prescriptions written for a given drug is publicly available on a periodic basis, this information does not disclose the rate at which drugs are being shipped to wholesalers, as that information is not publicly available. Analysts and investors did not know that Dura was shipping amounts of Ceclor CD to wholesalers well in excess of the amount justified by or necessary to keep pace with current prescription levels and thus Dura had created vastly excessive amounts of inventory of Ceclor CD in the distribution channel. While Dura reported

higher revenue and EPS during each of the quarters of 1997 from these shipments, these excessive inventory levels would eventually have to be worked off, causing sales and earnings to plummet.

66. Dura's statements regarding the Albuterol Spiros development were false and misleading when made. Telling investors that Dura had successfully completed clinical trials was highly misleading. It was all but certain that Dura's NDA for Albuterol Spiros would be rejected by the FDA and Dura would be required to completely redo its Phase III clinical human trials, and that the product would be delayed in reaching the market, if it ever reached the market. The configuration of the product Dura used to conduct clinical trials was unreliable and plagued by significant electro-mechanical problems. During clinical trials over 30% of the inhalers failed. One problem was that a light which came on to indicate that the medication dose had been successfully delivered operated erratically and did not consistently turn on due to a defect in a printed circuit board in the product. A second defect was that the small battery-operated motor in the product to drive a fan to push the medication dose into the patient did not reliably turn on upon inhalation as it was supposed to. Dura was unable to fix these problems prior to commencing Phase III clinical trials. Dura was conducting its Phase III clinical trials with versions of Albuterol Spiros that had these defects and, in fact, changed the device during clinical trials. Dura knew this would invalidate the Phase III clinical trials.

67. Dura also discovered serious problems with the stability of Albuterol in 1996 even before Phase III clinical

trials began. Once Albuterol was removed from its foil pouch container, as a dry powder it is subject to humidity and temperature problems and degradation. To address stability concerns, Dura conducted in-house temperature and humidity aging where Albuterol was aged for fixed intervals at 25 degrees Celsius and 75 percent relative humidity under industry and FDA guidelines. During this testing, Dura determined that Albuterol was unstable when aged and subject to clumping which reduced its efficacy when exposed to humidity.

68. Defendants knew, based on their prior experience with the FDA and the medical device industry, that the FDA would not approve an NDA for an unreliable product and unstable drug. For example, during clinical trials, Dura experienced an early return rate exceeding 30% for the Spiros device. Industry standards dictated that an NDA not be filed unless the early return rate was 1% or less. Defendants Garner, Prettyman, Spath, Woodbury and Brown were informed during executive management meeting held every Monday from 8:00 to 10:00 a.m. of the problems encountered during the Phase III clinical trials and of Albuterol's stability problems. Furthermore, defendants Garner and Prettyman attended Research and Development meetings, also held weekly, during which the Spiros device development team presented Phase III clinical trial results and stability test results. Minutes were also generated from these meetings and circulated to senior management.

69. To address the reliability problems plaguing the Spiros device during clinical trials, Dura decided to modify the device while the trials were ongoing. All device

modifications had to be approved by defendant Prettyman and others in his Regulatory Affairs department. Dura also kept careful records of the different configurations of the Spiros device labeled Rev D or Rev G. All modifications were documented in the clinical trial results and each test on each configuration was analyzed independently in a separate report. The Senior Project Engineer, Mike Ligotke, and Project Leader, Linda Gieschen, were responsible for drafting these reports.

70. Defendants were also aware of the reliability problems plaguing the Spiros device and the Albuterol stability problems from the Eisele List presented to senior management during an executive management meeting in 10/96. Bob Eisele, Vice President of Product Development, prepared a list that was contained in a 5-6 page document which set forth necessary items to be addressed before an NDA could be properly submitted. In fact, through the Eisele List, Dura's engineers recommended that further development of the Spiros device be completed and the stability of Albuterol be established before the NDA was submitted. Thus, senior management, including defendants Garner, Prettyman, Spath, Woodbury and Brown, were informed of these problems even before they were revealed during clinical trials. Defendants ignored Dura's engineers and proceeded with clinical trials without fixing these issues.

71. On 4/15/97, Oppenheimer & Company, Inc. ("Oppenheimer"), Alex. Brown, Robertson Stephens & Co. ("Robertson Stephens) and William Blair & Co. ("William Blair"), issued reports on Dura and the development of Spiros which were based on and repeated information provided in a

4/15/97 conference call with securities analysts in conjunction with the 1996 Annual Report and press release and in follow-up conversations with Garner or Newman. The Oppenheimer report stated:

> [T]he company's second business, that which is developing a proprietary drug delivery system for drugs administered by the inhalation route, moves ever closer to commercialization. Here, ***the company's Spiros dry powder, non-aerosol system will shortly be completing clinical trials using albuterol, the most widely-used inhaled asthma medicine, leading to filing for approval with the FDA late this year.***

The Alex. Brown report stated:

> The Company's efforts to develop new products are ***on track*** for an FDA filing in 2H 1997 for the first Spiros product, a dry powder formulation of albuterol

The Robertson Stephens report stated:

> Dura announced on March 6, 1997 that it had completed patient dosing in its Spiros albuterol trials. . . . ***[W]e still expect a 4Q98 approval and launch***. . . . Dura's Spiros manufacturing facilities appear to be close to commercial scale-up capacity.

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The William Blair report stated:

> We still expect Spiros albuterol to be filed in the second half of this year for marketing approval in the United States. . . . The company expects to file NDAs for Spiros beclomethasone and Spiros ipratropium in 1998 and 1999, respectively, with sales following as early as one year after NDA filings.

72. On 4/24/97, Oppenheimer issued a report on Dura which was based on and repeated information concerning Dura's Spiros development provided in conversation with Garner and Newman. The report stated:

> [The] Spiros product [will] become commercialized late next year. . . . This program has now progressed to the point that the first Spiros product, inhaled albuterol without the need for a propellant, should be submitted to the FDA before the end of this year.

73. On 4/28/97, UBS Securities ("UBS") issued a report on Dura which was based on and repeated information concerning Dura's Spiros development provided in conversations with Dura executives, including Garner or Newman. The report stated:

> ***Without Spiros, Dura would be strictly a high-growth speciality marketing company, acting as a consolidator of niche respiratory product lines.*** . . .

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> What differentiates Dura from a typical marketing company is its interests in becoming more "fully-integrated" mainly through developing its own platform technology, the Spiros dry powder inhaler. We believe that this technology will provide an important growth catalyst following the second half 1997 NDA filing and our expectations for approval in the U.S. in the second half of 1998. Based on our projections, Spiros revenues will add about $58 million to Dura's current sales base in 1999.

74. On 5/7/97, Dura announced it had acquired the Nasarel/Nasalide spray product line from Roche Holding AG. Defendant Garner stated that "The Nasarel(tm) and Nasilide(tm) products are ideal for Dura as they fit squarely within our respiratory focus and add a new respiratory category to our product portfolio, diversifying our offering to high-prescribing physicians and further leveraging our sales representatives' time in every sales call."

75. On 5/7/97-5/9/97, UBS, Vector Securities Intl. ("Vector") and William Blair issued reports on Dura after discussions with Garner and Newman following the Roche Holding AG announcement which were based on and repeated information provided by them. The 5/7/97 UBS report stated:

> Dura expects to have 350 reps in place by the time of the launch of the first Spiros inhaler product (Spiros albuterol) in late-1998.

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The 5/8/97 Vector report stated:

> Separately, the company is still on track to submit their first Spiros NDA filing in the second half of 1997 for the dry-powder delivery of albuterol. The addition of 50 sales people further prepares Dura for the first Spiros product launch, potentially in the second half of 1998.

The 5/9/97 William Blair report stated:

> Dura expects to have about 350 sales reps in time for the anticipated introduction of Spiros albuterol in late 1998.

76. On 5/30/97, Alex. Brown and Vector issued reports on Dura and the Spiros development after discussions with Dura executives, including Garner and Newman, which were based on and repeated information provided by them. The Alex. Brown report stated:

> DURA will file its first NDA for Spiros albuterol with the FDA in 2H 1997, which will compete in the sizable $670 million market for albuterol, and could add $100 million in revenues by 2000 ....

The Vector Securities report stated:

> [W]e note that the company still appears on track to submit its first Spiros NDA filing in the second half of 1997. . . .

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77. Dura's 5/7/97 announcement was false and misleading for the reasons set forth in ¶¶52-53.

78. Defendants had knowledge of this false statement for the same reasons set forth in ¶54.

79. On 6/5/97, Dura issued a release stating:

> Dura . . . announced the completion of the clinical trials necessary for a new drug application (NDA) submission for the Albuterol Spiros™ product. . . .
>
> "Our clinical trials for Albuterol Spiros™ were designed to demonstrate comparability of the Spiros™ delivery system with a leading branded metered dose inhaler product," noted David S. Kabakoff, Dura's Executive Vice President and President and CEO of Spiros Corp. "We are pleased with the results to date and are preparing the NDA for filing in the latter half of this year."

80. Dura's announcement that clinical trials had been completed on 6/5/97 and statements made to and repeated by securities analysts in 5/97 were false and misleading for the reasons set forth in ¶¶66-70. In addition, telling investors that clinical trials had been successfully completed and that the Company was on track to file its NDA later in 1997 was also false and misleading because Dura representatives, including defendants Garner and Prettyman, attended a pre-filing meeting with the FDA in 5/97 in the FDA's offices in the Washington D.C. area. During that meeting, the FDA

informed Dura that it was concerned with the Spiros device's reliability and with Albuterol's stability.

81. Defendants had scienter of the falsity of the statements regarding the completion of clinical trials for the reasons set forth in ¶¶66-70. Defendants' scienter is further demonstrated by the pre-filing meeting with the FDA attended by defendants Garner and Prettyman in 5/97. Furthermore, these defendants' scienter is also demonstrated through their regular attendance at the weekly Research and Development meetings to discuss the Spiros device. At one such meeting, shortly before the pre-filing meeting with the FDA, defendant Garner asked the Spiros development team about the inhaler's reliability. During that meeting, the Spiros development team again informed defendants Garner and Prettyman that over 30% of the inhalers failed during clinical trials.

82. Between 6/24-26/97, defendant Newman appeared at the William Blair 1997 Investment Conference in Chicago. As reported by William Blair on 6/30/97, Newman told analysts, money and portfolio managers, institutional investors, brokers and stock traders in a formal presentation that:

> • Overall, the company was performing well in both the acquisition and Spiros product development fronts. Dura's recently acquired key product, Ceclor CD, continued to gain market share – it had an approximate 17.9% share of the cefaclor market, versus 16.9% at the end of April and 7.5% at the end of 12/96.

> • Dura still planned to file an Albuterol Spiros product by year's end.
>
> • One of the main reasons Dura could capture additional licensing/co-promotion agreements was that it had a highly specialized sales force of about 250 reps that were focused on the respiratory prescription market. Although Dura's sales force was relatively small, it still could call on almost 45-50% of the high respiratory prescription writers.
>
> • The Company also was continuing to develop the Spiros product line aggressively. Albuterol Spiros NDA should be filed by the fall of 1997.

83. The statements made during the William Blair Investment Conference detailed above were false or misleading when issued and made with scienter for the reasons described in ¶¶66-70, 80-81 above.

84. By 7/2/97, Dura stock had recovered to $44-7/8 from its 4/97 low of $22-3/4. As Dura's stock soared higher, despite their knowledge that Dura's own engineers thought it was premature to file an NDA, that over 30% of the Spiros inhalers failed during clinical trials, that Albuterol was unstable, and that in 5/97 in a pre-filing meeting the FDA had raised the same issues Dura's own engineers warned about and for which Dura had no satisfactory clinical data, Garner, Spath, Cook, Brown and Newman unloaded 188,626 shares of their Dura stock, pocketing $7,345,527 in illegal insider-trading proceeds.

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85. On 7/15/97, Dura reported better-than-expected Q2 1997 results in a press release, stating:

> Net income for the second quarter ended June 30, 1997 totaled $9.3 million, or $0.20 per share, on revenues of $43.6 million compared to net income of $4.6 million, or $0.12 per share, on revenues of $18.8 million in the second quarter ended June 30, 1996.
>
> * * *
>
> Commenting on the results for the quarter, Dura Chairman, President and Chief Executive Officer Cam L. Garner stated, "We are pleased with Dura's performance in the second quarter of 1997. Ceclor® CD (cefaclor extended release tablets) and Keftab® (cephalexin HC1, USP) . . . have been well received by physicians, who are responding favorably to our promotional efforts. We are also benefitting from our more experienced and expanded sales force, which currently totals approximately 225 representatives. . . .
>
> . . . We completed clinical trials necessary for NDA (new drug application) submission and are on track to file the Albuterol Spiros™ NDA on behalf of Spiros Corp. in the second half of 1997.

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86. The statements regarding Dura's Q2 1997 results were false and misleading when issued. The true but concealed facts were: -

(a) Sales of Dura's major drug products were flat or declining, especially Ceclor CD, whose sales levels were dropping throughout the Class Period;

(b) Dura was encountering serious and persistent problems with its sales force which was inadequately trained, was suffering from very high turnover and was insufficient in number and skill to adequately market Dura's drug products, including Ceclor CD, Keftab and Rondec;

(c) In order to cover up the sales shortfalls described above, Dura was engaging in a subterfuge to artificially inflate its revenues and EPS by shipping excessive amounts of Ceclor CD and other products to wholesalers, who were enticed to take the product by price discounts, extended payment terms and/or other incentives. As a result, Dura's Ceclor CD and other product inventories in the distribution channel were greatly in excess of the normal one-month supply. As a result of this practice, Dura's Ceclor CD sales were artificially inflated and Dura's insiders knew that as a result of the "borrowing" of millions of dollars of sales of Ceclor CD from future periods, Dura's sales of Ceclor CD would inevitably fall sharply once this practice stopped;

(d) Sales of Dura's Nasalide spray products were also poor and well below expectations;

(e) Dura's Rondec and Dura-Vent product lines were suffering very poor sales, declining so rapidly and performing so poorly that Dura would not be able to recover its remaining investment in Rondec from those sales; and

(f) Dura had falsified and artificially inflated its Q1 and Q2 1997 EPS by failing to take required write-downs on the carrying value of its investment in the Rondec product line, which were required because the sales of that product line had so declined and were so poor that Dura could not recover its remaining investment in Rondec.

87. Defendants had scienter of the false and misleading Q2 1997 results because Garner, Prettyman, Spath, Woodbury and Brown were the top executives of Dura. They ran Dura as "hands-on" managers, dealing with the important issues facing Dura's business, such as sales of its Ceclor CD/Keftab, Rondec, Nasalide/Nasarel and Dura-Vent products, the development of its new Albuterol Spiros product, the issuing of Dura's SEC filings, press releases and financial statements, Dura's investment in Rondec and the development and expansion of its sales force. Garner, Prettyman, Spath, Woodbury and Brown each attended the weekly executive management meetings from 8:00 to 10:00 a.m. every Monday.

88. Because increased sales of Ceclor CD/Keftab, Rondec, Nasalide/Nasarel and Dura-Vent products, the successful development of and substantial sales of Dura's Albuterol Spiros product, and the continuing sales of Dura's core products were indispensable elements to Dura meeting its internally budgeted and publicly disseminated 1998 and 1999 revenue and EPS forecasts, defendants constantly monitored each of these key factors affecting Dura's business.

89. Each of the Individual Defendants, because of their top executive positions with Dura and involvement in the day-to-day management of its business, actually knew from internal corporate documents and conversations with other corporate officers and employees and their attendance at management and Board meetings, the adverse non-public information about the poor sales of Dura's Ceclor CD/Keftab, Rondec, Nasalide/Nasarel and Dura-Vent products, the serious problems in the development of Dura's Spiros drug development system, Dura's falsification of its reported Q2 1997 EPS, and Dura's deteriorating revenue and EPS prospects.

90. The Dura Defendants closely monitored the performance of Dura's business via internal reports generated on a daily, weekly and monthly basis. Among the specialized reports prepared were drug-by-drug sales volume summaries, year-over-year sales volume comparisons of each Dura product, sales volume comparisons of Dura drugs to competitor drugs, sales revenue reports, and daily, weekly and monthly reports on prescription volumes, competitor prescription volumes, and market share. On a monthly basis, Dura's Information Technology department, after receiving information from IMS, a service that tracks prescription drug sales, would prepare reports comparing actual versus planned sales of Dura's drug products. Through such reports, which were prepared for and disseminated by defendant Spath, defendants were kept apprised of Dura's drug sales and knew that such sales were below plan and insufficient for Dura to achieve continued growth in sales and earnings.

91. The monthly sales reports showed, for example, that Ceclor CD sales began dropping around March-April 1997, and significantly worsened during the summer of 1997. These reports showed that sales were 25-40% below internal projections at that time. Monthly sales reports showed that Ceclor CD sales dropped from 47,288 in 3/97 to 39,808 in 5/97 to 24,797 in 7/97.

92. The Finance Department also distributed monthly financial reports comparing Dura's actual financial results to projected results. Thus, each Dura Defendant was apprised of the sales of every Dura product so that they knew where Dura stood in terms of the sale of and demand for its products as well as Dura's actual results compared to plan. Thus, the Dura Defendants were constantly aware of the prescription rate for its products and knew that excess inventory was building up with distributors and that Dura was not recouping its investments in certain drugs.

93. Dura recognized revenue on the sale of a product when it shipped the product to drug wholesalers. These drug wholesalers in turn would resell the drug to pharmacies, drug chains or even individual physicians. Dura did not publicly disclose to analysts or investors sales of each of its various drug products, *i.e.*, shipments to wholesalers. Thus, analysts and investors were completely dependent upon what Dura told them regarding sales of these products, as shipment-to-wholesaler data is not publicly available. While the number of prescriptions written for a given drug is publicly available on a periodic basis, this information does not disclose the rate at which drugs are being shipped to wholesalers, as that information is not publicly available. Analysts and investors

did not know that Dura was shipping amounts of Ceclor CD to wholesalers well in excess of the amount justified by or necessary to keep pace with current prescription levels and thus Dura had created vastly excessive amounts of inventory of Ceclor CD in the distribution channel. While Dura reported higher revenue and EPS during each of the quarters of 1997 from these shipments, these excessive inventory levels would eventually have to be worked off, causing sales and earnings to plummet.

94. On 7/15/97, Vector, Alex. Brown, William Blair, Robertson Stephens and Oppenheimer issued reports on Dura which were based on and repeated information provided in a 7/15/97 conference call following the Q2 1997 press release and in follow-up conversations concerning the Spiros development with Garner and Newman. The Vector report stated:

> * The company also reiterated that it remains on track to file the Albuterol Spiros NDA (new drug application) in the second half 1997.

The Alex. Brown report stated:

> Spiros Is The Platform For Long-Term Growth
>
> ***Efforts to develop new products are on track***; Spiros albuterol . . . could be on the market in late 1998, with initial sales of $10 million growing to over $55 million by 2000. . . .

* * *

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[W]e believe ***upside could emanate from the launch of Spiros albuterol in mid-1998.***

The William Blair report stated:

> We still expect Spiros albuterol to be filed in the second half of this year for marketing approval in the United States. . . . The company expects to file NDAs for Spiros beclomethasone and Spiros ipratropium in 1998 and 1999, respectively, with sales following as early as one year after NDA filings. . . . These products should contribute significantly to Dura's long-term revenue and earnings growth.

The Robertson Stephens report stated:

Spiros continue[s] on track or ahead of schedule.

The Oppenheimer report stated:

> [T]he company's second business, which is developing a proprietary drug delivery system for drugs administered by the inhalation route, moves ever closer to commercialization.

95. Dura's statement in its 7/15/97 press release and statements made to and repeated by securities analysts regarding the Spiros development were false and misleading when made.

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96. Telling investors that Dura had successfully completed clinical trials was highly misleading. It was all but certain that Dura's NDA for Albuterol Spiros would be rejected by the FDA and Dura would be required to completely redo its Phase III clinical human trials, and that the product would be delayed in reaching the market, if it ever reached the market. The configuration of the product Dura used to conduct clinical trials was unreliable and plagued by significant electro-mechanical problems. During clinical trials, over 30% of the inhalers failed. One problem was that a light which came on to indicate that the medication dose had been successfully delivered operated erratically and did not consistently turn on due to a defect in a printed circuit board in the product. A second defect was that the small battery-operated motor in the product to drive a fan to push the medication dose into the patient did not reliably turn on upon inhalation as it was supposed to. Dura was unable to fix these problems prior to commencing Phase III clinical trials. Dura was conducting its Phase III clinical trials with versions of Albuterol Spiros that had these defects and, in fact, changed the device during clinical trials. Dura knew this would invalidate the Phase III clinical trials.

97. Dura also discovered serious problems with the stability of Albuterol in 1996 even before Phase III clinical trials began. Once Albuterol was removed from its foil pouch container, as a dry powder it is subject to humidity and temperature problems and degradation. To address stability concerns, Dura conducted in-house temperature and humidity aging where Albuterol was aged for fixed intervals at 25 degrees Celsius and 75 percent relative humidity under industry and FDA guidelines. During this testing, Dura

determined that Albuterol was unstable when aged and subject to clumping which reduced its efficacy when exposed to humidity.

98. Defendants knew, based on their prior experience with the FDA and the medical device industry, that the FDA would not approve an NDA for an unreliable product and unstable drug. For example, during clinical trials, Dura experienced an early return rate exceeding 30% for the Spiros device. Industry standards dictated that an NDA not be filed unless the early return rate was 1% or less. Defendants Garner, Prettyman, Spath, Woodbury and Brown were informed during executive management meeting held every Monday from 8:00 to 10:00 a.m. of the problems encountered during the Phase III clinical trials and of Albuterol's stability problems. Furthermore, defendants Garner and Prettyman attended Research and Development meetings, also held weekly, during which the Spiros device development team presented Phase III clinical trial results and stability test results. Minutes were also generated from these meetings and circulated to senior management.

99. To address the reliability problems plaguing the Spiros device during clinical trials, Dura decided to modify the device while the trials were ongoing. All device modifications had to be approved by defendant Prettyman and others in his Regulatory Affairs department. Dura also kept careful records of the different configurations of the Spiros device labeled Rev D or Rev G. All modifications were documented in the clinical trial results and each test on each configuration was analyzed independently in a separate report. The Senior Project Engineer, Mike Ligotke, and

Project Leader, Linda Gieschen, were responsible for drafting these reports.

100. Defendants were also aware of the reliability problems plaguing the Spiros device and the Albuterol stability problems from the Eisele List presented to senior management during an executive management meeting in 10/96. Bob Eisele, Vice President of Product Development, prepared a list that was contained in a 5-6 page document which set forth necessary items to be addressed before an NDA could be properly submitted. In fact, through the Eisele List, Dura's engineers recommended that further development of the Spiros device be completed and the stability of Albuterol be established before the NDA was submitted. Thus, senior management, including defendants Garner, Prettyman, Spath, Woodbury and Brown, were informed of these problems even before they were revealed during clinical trials. Defendants ignored Dura's engineers and proceeded with clinical trials without fixing these issues.

101. Furthermore, defendants Garner and Prettyman attended a pre-filing meeting with the FDA in 5/97 in the FDA's offices in the Washington D.C. area. During that meeting, the FDA informed Dura that it was concerned with the Spiros device's reliability and with Albuterol's stability. Defendants' scienter is also demonstrated through their regular attendance of the weekly Research and Development meeting to discuss the Spiros device. At one such meeting, shortly before the pre-filing meeting with the FDA, defendant Garner asked the Spiros development team about the inhaler's reliability. During that meeting, the Spiros development team again informed defendants Garner and Prettyman that over 30% of the inhalers failed during clinical trials.

102. On 7/25/97, Dura sold $287.5 million in convertible notes with the help of Merrill Lynch. This was the largest securities offering in Dura's history.

103. On 8/11/97, Vector issued a report on Dura after discussions with Garner and Newman during the 7/97 convertible debenture Roadshow conferences and which was based on and repeated information provided by them. The report stated:

> We still do not believe that Spiros is totally factored into the current stock price. An NDA filing for the first Spiros product, for albuterol, should occur in the second half of this year ***with a market launch expected in the second half of 1998***.

104. On 8/19/97, Piper Jaffray issued a report on Dura after discussions with Garner and Newman which was based on and repeated information provided by them. The report stated:

> • Spiros is on track for a late 1998 launch. . . .
>
> • The convergence of these two arms of Dura's strategy upon the launch of Spiros ***will be a watershed event for the company, marking Dura as a leader in the respiratory pharmaceutical market.***

* * *

> Spiros has outstanding potential as a drug inhalation device. . . . The Spiros system . . . ***possesses significant advantages over alternative inhalers currently marketed or in development***. We expect Dura to file a new drug application (NDA) relating to a Spiros formulation of albuterol (the most widely prescribed asthma drug) this fall and receive approval in the fall of 1998.

105. On 9/11/97 - 9/12/97 Piper Jaffray, Vector and Montgomery Securities issued reports on Dura after discussions with Garner and Newman, each of which was based and repeated information provided by them. The 9/11/97 Piper Jaffray report stated:

> Second, Spiros will likely begin to account for more of Dura's valuation as the filing of the Spiros albuterol NDA in the next couple of months brings Spiros into the limelight.

The 9/11/97 Vector report stated:

> We expect Spiros albuterol to be launched in the second half of 1998 when we estimate it will generate $20 million in sales.

The 9/12/97 Montgomery Securities report stated:

> Spiros albuterol is expected launch in 1998 with anticipated sales of nearly $50 million in 1999. We also anticipate launch of Spiros beclomethasone in 1999 and Spiros ipratropium in 2000.

106. On 10/8/97, Dura representatives appeared at the UBS Life Science Conference. The Company revealed that an upcoming NDA filing for its first Spiros respiratory product line was expected "'within days.'" As reported by UBS, Dura further "presented compelling market share data with respect to Ceclor CD's continuing progress in the U.S. cefaclor cephalosporin franchise. Moving into the seasonal flu season and reflecting increased promotional support behind the brand, Ceclor CD registered nearly a three-point sequential increase in market share between August to September."

107. By 10/8/97, Dura's stock traded at $52-1/4 – its then all-time high price. On 10/10/97, Dura announced it was going to exercise its option to buy Spiros I's stock for Dura stock and was going to launch Spiros II via the sale of units to the public, including warrants to buy Dura stock.

108. On 10/8/97, UBS issued a report on Dura which was based on and repeated information provided at the UBS Life Science Conference and in conversations with Garner and Newman. The report stated:

> Dura Pharmaceuticals at the UBS Life Science Conference indicated that an upcoming NDA filing for its first Spiros respiratory product line . . . was expected "within days." This regulatory filing reinforces our confidence in a late-1998 commercialization of this new dry powder inhaler system, representing the first of three Spiros product lines scheduled for steady roll-out over the 1998-2000 period.

109. Defendants' statement to and repeated by securities analysts during conference calls, one-on-one sessions and analyst conferences between 8/11/97 and 10/8/97, as set forth in ¶¶103-106, 108 above, regarding the imminent filing of the NDA for Albuterol Spiros were false and misleading for the reasons set forth in ¶¶96-101.

110. Defendants' scienter of the falsity of these statements is set forth in ¶¶96-101.

111. On 10/14/97, Dura reported better-than-expected Q3 1997 results via a release headlined and stating:

> DURA PHARMACEUTICALS REPORTS RECORD EARNINGS FOR THIRD QUARTER 1997
>
> Dura . . . today reported record earnings for both the third quarter and nine months year-to-date of 1997, compared to the same periods last year.
>
> Net income for the third quarter ended September 30, 1997 totaled $11.3 million, or $0.24 per share, on revenues of $43.3 million compared to net income of $5.8 million, or $0.14 per share, on revenues of $25.9 million for the third quarter ended September 30, 1996. . . .
>
> The increase in revenues was primarily the result of growth in sales of respiratory pharmaceuticals, which rose 91% to $36.1 million

in the third quarter of 1997 compared to $18.9 million in the third quarter of 1996. Pharmaceutical sales growth is principally attributable to the impact of new product acquisitions and introductions, such as Ceclor® CD (cefaclor extended release tablets) and Nasarel® . . . and the expansion of the sale force . . . .

* * *

"We are pleased with Dura's sales performance in the third quarter of 1997, particularly in light of the seasonal slow-down that we typically experience in the summer quarter," stated Cam L. Garner, Dura's Chairman, President and CEO.

112. In a follow-up conference call on 10/14/97, Dura management continued to support the mistaken belief that it was experiencing strong sales. As reported by Vector on 10/15/97:

> * Of note, during the conference call, management suggested that, excluding acquisitions, earnings for 1998 could run in the "low $1.40's range". . . .
>
> * * *
>
> As for the sales force expansion, the company projects that it will have 300 sales reps by the end of the year and 350 reps at the point that Spiros Albuterol is launched.

113. On 10/14/97-10/15/97, Dura's stock reached its all-time high of $53.

114. The statements regarding Dura's Q3 1997 results were false and misleading when issued. The true but concealed facts were:

(a) Sales of Dura's major drug products were flat or declining, especially Ceclor CD, whose sales levels were dropping throughout the Class Period;

(b) Dura was encountering serious and persistent problems with its sales force which was inadequately trained, was suffering from very high turnover and was insufficient in number and skill to adequately market Dura's drug products, including Ceclor CD, Keftab and Rondec;

(c) In order to cover up the sales shortfalls described above, Dura was engaging in a subterfuge to artificially inflate its revenues and EPS by shipping excessive amounts of Ceclor CD and other products to wholesalers, who were enticed to take the product by price discounts, extended payment terms and/or other incentives. As a result, Dura's Ceclor CD and other product inventories in the distribution channel were greatly in excess of the normal one-month supply. As a result of this practice, Dura's Ceclor CD sales were artificially inflated and Dura's insiders knew that as a result of the "borrowing" of millions of dollars of sales of Ceclor CD from future periods, Dura's sales of Ceclor CD would inevitably fall sharply once this practice stopped;

(d) Sales of Dura's Nasalide spray products were also poor and well below expectations;

(e) Dura's Rondec and Dura-Vent product lines were suffering very poor sales, declining so rapidly and performing so poorly that Dura would not be able to recover its remaining investment in Rondec from those sales; and

(f) Dura had falsified and artificially inflated its Q1 and Q2 1997 EPS by failing to take required write-downs on the carrying value of its investment in the Rondec product line, which were required because the sales of that product line had so declined and were so poor that Dura could not recover its remaining investment in Rondec.

115. Defendants had scienter of the false and misleading Q3 1997 results because Garner, Prettyman, Spath, Woodbury and Brown were the top executives of Dura. They ran Dura as "hands-on" managers, dealing with the important issues facing Dura's business, such as sales of its Ceclor CD/Keftab, Rondec, Nasalide/Nasarel and Dura-Vent products, the development of its new Albuterol Spiros product, the issuing of Dura's SEC filings, press releases and financial statements, Dura's investment in Rondec and the development and expansion of its sales force. Garner, Prettyman, Spath, Woodbury and Brown each attended the weekly executive management meetings from 8:00 to 10:00 a.m. every Monday.

116. Because increased sales of Ceclor CD/Keftab, Rondec, Nasalide/Nasarel and Dura-Vent products, the successful development of and substantial sales of Dura's Albuterol Spiros product, and the continuing sales of Dura's

core products were indispensable elements to Dura meeting its internally budgeted and publicly disseminated 1998 and 1999 revenue and EPS forecasts, defendants constantly monitored each of these key factors affecting Dura's business.

117. Each of the Individual Defendants, because of their top executive positions with Dura and involvement in the day-to-day management of its business, actually knew from internal corporate documents and conversations with other corporate officers and employees and their attendance at management and Board meetings, the adverse non-public information about the poor sales of Dura's Ceclor CD/Keftab, Rondec, Nasalide/Nasarel and Dura-Vent products, the serious problems in the development of Dura's Spiros drug development system, Dura's falsification of its reported Q3 1997 EPS, and Dura's deteriorating revenue and EPS prospects.

118. The Dura Defendants closely monitored the performance of Dura's business via internal reports generated on a daily, weekly and monthly basis. Among the specialized reports prepared were drug-by-drug sales volume summaries, year-over-year sales volume comparisons of each Dura product, sales volume comparisons of Dura drugs to competitor drugs, sales revenue reports, and daily, weekly and monthly reports on prescription volumes, competitor prescription volumes, and market share. On a monthly basis, Dura's Information Technology department, after receiving information from IMS, a service that tracks prescription drug sales, would prepare reports comparing actual versus planned sales of Dura's drug products. Through such reports, which were prepared for and disseminated by defendant Spath,

defendants were kept apprised of Dura's drug sales and knew that such sales were below plan and insufficient for Dura to achieve continued growth in sales and earnings.

119. The monthly sales reports showed, for example, that Ceclor CD sales began dropping around March-April 1997, and significantly worsened during the summer of 1997. These reports showed that sales were 25-40% below internal projections at that time. Monthly sales reports showed that Ceclor CD sales dropped from 47,288 in 3/97 to 39,808 in 5/97 to 24,797 in 7/97.

120. The Finance Department also distributed monthly financial reports comparing Dura's actual financial results to projected results. Thus, each Dura Defendant was apprised of the sales of every Dura product so that they knew where Dura stood in terms of the sale of and demand for its products as well as Dura's actual results compared to plan. Thus, the Dura Defendants were constantly aware of the prescription rate for its products and knew that excess inventory was building up with distributors and that Dura was not recouping its investments in certain drugs.

121. Dura recognized revenue on the sale of a product when it shipped the product to drug wholesalers. These drug wholesalers in turn resell the drug to pharmacies, drug chains or even individual physicians. Dura did not publicly disclose to analysts or investors sales of each of its various drug products, *i.e.*, shipments to wholesalers. Thus, analysts and investors were completely dependent upon what Dura told them regarding sales of these products, as shipment-to-wholesaler data is not publicly available. While the number

of prescriptions written for a given drug is publicly available on a periodic basis, this information does not disclose the rate at which drugs are being shipped to wholesalers, as that information is not publicly available. Analysts and investors did not know that Dura was shipping amounts of Ceclor CD to wholesalers well in excess of the amount justified by or necessary to keep pace with current prescription levels and thus Dura had created vastly excessive amounts of inventory of Ceclor CD in the distribution channel. While Dura reported higher revenue and EPS during each of the quarters of 1997 from these shipments, these excessive inventory levels would eventually have to be worked off, causing sales and earnings to plummet.

122. On 10/14/97-10/15/97, Oppenheimer, Alex. Brown, Vector and Hambrecht & Quist issued reports on Dura which were based on and repeated information provided in the 10/14/97 conference call and in follow-up conversations with Garner or Newman. The 10/14/97 Oppenheimer report stated:

> [T]he company's second business, developing a proprietary drug delivery system for drugs administered by the inhalation route, moves ever closer to commercialization. Here, the company's Spiros dry powder, non-aerosol system will shortly be submitting its first marketing applications to the FDA for albuterol, the most widely-used inhaled asthma medicine. The expected November filing keeps the company on track for initial commercial sales of this product at the end of 1998. . . .

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The 10/15/97 Alex. Brown report stated:

> The Company plans to file its first NDA for Spiros albuterol in November 1997, and it could be on the market in late 1998, with initial projected sales of $10 million expected to grow to over $55 million by 2000, further leveraging Dura's growing marketing infrastructure. A Phase III trial of Spiros beclomethasone, an inhaled steroid for the treatment of asthma, has just begun enrolling patients, and an NDA could be filed in late 1998.

The 10/15/97 Vector report stated:

> [W]e expect that the company will file an NDA for Spiros Albuterol in November of this year and launch the product in the second half of 1998. Dura's confidence in this product has been clearly communicated by the recent announcement that Dura will buy Spiros Development Corp. . . . Dura is targeting the second half of 1999 for approval of Spiros beclomethasone.

The 10/15/97 Hambrecht & Quist report stated:

> Spiros and Pipeline Update
>
> * * *
>
> ***Spiros albuterol has apparently performed well in clinical trials***. . . . An NDA filing is expected before the end of 1997. We estimate approval in late 1998, with a launch in early 1999. . . .

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123. On 11/10/97, Dura stated in a release:

> Dura . . . on behalf of Spiros Development Corporation (Spiros Corp.) today announced that it has submitted a new drug application (NDA) with the FDA for Albuterol Spiros™. . . . Three pivotal studies in addition to a number of dose finding and performance verification studies were conducted for the submission.
>
> * * *
>
> "Submission of the first Spiros™ NDA is an exciting milestone for Spiros Corp. and Dura," commented Cam L. Garner, Dura's Chairman, President and CEO. "It represents a significant advancement in the execution of our strategy to establish Dura as a leader in the respiratory marketplace."

124. On 12/17/97, Dura and Spiros II sold 5.5 million Spiros II units at $16 per unit, raising $88 million in needed new capital. Each unit sold consisted of one share of stock of Spiros II and one warrant to purchase one-fourth of one share of Dura common stock.

125. Dura's announcements regarding the submission of the Spiros delivery device NDA to the FDA on 11/10/97 and the completion of the Spiros II offering on 12/17/97 and statements made to and repeated by securities analysts regarding the NDA for Spiros on 10/14/97 and 10/15/97 were false and misleading and made with scienter for the reasons

set forth in ¶¶96-101. The falsity of these statements and defendants' scienter thereof is also demonstrated by the internal dissension existing at Dura in 10/97 between defendants themselves about whether to even file the NDA for the Spiros device. In late October or early November 1997, a meeting was held to discuss the NDA filing. Defendants Garner and Prettyman along with Kabakoff and Damecki attended the meeting during which Prettyman made it very clear that he did not want to file the NDA, for which his department, Regulatory Affairs, was responsible. Prettyman was against filing the NDA because, based on his prior experience – Prettyman worked for the FDA for over ten years prior to working for Dura – he knew the NDA would not be approved by the FDA. Despite this, defendant Garner and Kabakoff forced Prettyman to file the NDA. Shortly after this meeting, the NDA was submitted on 11/10/97.

126. Defendants' scienter of the serious problems plaguing the reliability of the Spiros device causing over 30% of the devices to fail and thus their scienter of the falsity of the NDA filing announcement, the Spiros II funding and their statements to analysts is also demonstrated by the defendants' decision to retain Wyle Labs to conduct HALT. Senior executives at Dura were so concerned about the inhaler's reliability problems and the mid-clinical-trial modifications that were made to the device that the decision was made to contract with an outside testing facility, Wyle Labs, to conduct HALT. HALT are extreme condition tests designed to identify potential operational failures in a device. Dura contracted with Wyle Labs to conduct these tests while Phase III clinical trials were still ongoing. Ed Dusel, Senior Engineering Development Manager, managed the Wyle Lab testing and

Mike Ligotke, Senior Project Manager, analyzed the test results. Dura gave Wyle Labs inhaler configurations Revs D, G, H, and J of the device. Dura used the HALT results from Wyle Labs in a 9/98 amendment to Dura's NDA to try to demonstrate that the different inhaler configurations tested in Phase III clinical trials as well as the concurrent HALT resulted in progressively improved operational reliability. Thus, defendants knew that Dura's Phase III clinical trials, upon which the NDA was based, were inadequate to obtain FDA approval.

127. Defendants' scienter of the falsity of these statements is also demonstrated by the massive insider bailout of Dura stock immediately after defendant Prettyman lost the power struggle over whether to file the NDA to defendant Garner. On 11/5/97, defendant Prettyman sold 15,000 shares and pocketed over $728,000 – his only selling during the Class Period – despite his expressed belief that the Spiros device NDA would not be approved. In total, while Dura's stock continued to trade at artificially inflated prices near its all-time high, between 11/3/97 and 1/6/98, Garner, Woodbury, Prettyman, Newman, Spath, and Cook unloaded 197,607 shares of their Dura stock, pocketing $9.2 million in illegal insider-trading proceeds.

128. On 1/20/98, Dura reported better-than-expected Q4 1997 results via a release stating:

> Dura . . . today announced results for the fourth quarter and year ended December 31, 1997. Dura reported record revenues of $53.5 million and $181.3 million for the quarter and the full

year, respectively. . . . If . . . one-time charges were excluded, Dura would have reported record net income of $18.0 million, or $0.37 per share in the quarter, and $47.4 million, or $0.99 per share for the year, compared to a net income of $9.9 million, or $0.22 per share for the fourth quarter of 1996 and $24.3 million, or $0.60 per share for the full year 1996. . . .

* * *

Revenues from the sale of respiratory pharmaceuticals rose 89% to $150.5 million in 1997 compared to $79.6 million 1996, due largely to product acquisitions and the increased productivity of the Company's expanded sales force. . . .

Commenting on the results for the year, Dura Chairman, President and Chief Executive Officer Cam L. Garner stated, "During the past year we significantly strengthened both the pharmaceutical product marketing and the Spiros development arms of our business . . . We have continued to demonstrate our capabilities as a respiratory marketing force as shown by the growth of our Ceclor(R) CD market share of the oral solid cefaclor market from 8% at the beginning of 1997 to 25% by year-end.

129. The statements regarding Dura's Q4 1997 results were false and misleading and made with scienter for the same reasons stated in ¶¶114-121.

130. On 1/20/98-1/21/98, Vector, Merrill Lynch, Oppenheimer and Hambrecht & Quist issued reports on Dura which were based on and repeated information provided in a 1/20/98 conference call following the Q4 1997 press release and in follow-up conversations with Garner or Newman. The 1/20/98 Vector report stated:

> A late 1998/early 1999 time frame for a launch of ***Spiros albuterol***, now with the proposed trade name ***AlSpiros, was confirmed by the company***.

The 1/20/98 Merrill Lynch report stated:

> In the meantime, we expect steady progress with the FDA's review of the Spiros Dry Powder inhaler with albuterol, (AlSpiros) the most prescribed asthma drug. ***Final approval is likely by year end***. . . .
>
> . . . By 2002, we believe that Spiros based products could contribute up to 50% of corporate revenue.

The 1/20/98 Oppenheimer report stated:

> [T]he company's Spiros dry-powder, non-aerosol system will shortly be reviewed by [the] FDA following its acceptance of Dura's first marketing

application to the FDA for albuterol, the most widely-used inhaled asthma medicine. The recent FDA acceptance of this filing keeps the company on track for the product's approval by the end of 1998.

The 1/21/98 Hambrecht & Quist report stated:

> Spiros albuterol (now called AlSpiros) is the front-runner, with an NDA filed in November, and an acceptance of that filing issued by the FDA last week, ***everything is on schedule (pending FDA approval) for an early 1999 launch***. . . .

131. On 1/29/98, Merrill Lynch issued a report on Dura which was based on and repeated information provided in the 1/20/98 conference call and in follow-up conversations with Garner or Newman. The report stated:

> [W]e expect steady progress with the FDA's review of the Spiros Dry Powder inhaler with Albuterol, (AlSpiros) the most prescribed asthma drug. ***Final approval is likely by year end***.

132. By early 2/98, Dura's stock had begun to decline in price. Dura's top insiders nevertheless continued to reassure analysts that Dura's fundamentals remained strong.

133. Each of defendants' statements made to securities analysts between 1/20/98 and 1/29/98 described above were false or misleading when issued. Assuring investors that approval of the NDA was likely during 1998 was false and

misleading as defendants knew that the clinical data submitted in support of the NDA showed that the inhaler had a 30 percent failure rate and that the data was inadequate to demonstrate Albuterol's stability. The falsity of these statements, and defendants' scienter thereof, is further demonstrated by the reasons set forth in ¶¶96-101, 125-127.

134. On 2/24/98, after the close of trading, Dura shocked the market by revealing that it was experiencing slower Ceclor CD and Nasarel/Nasalide sales and needed to increase Dura's sales force from 270 representatives to over 450. In a conference call with analysts, Dura admitted that both increased competition from other antibiotics, as well as a need for its sales force to increase physician calls and sampling rates, was adversely affecting Ceclor CD's sales. Dura hoped that its new, much larger sales force would now be able to properly market Ceclor CD, and correct the sales decline. Investors were stunned by these revelations. Dura's stock price collapsed from $39-1/8 on 2/24 to $20-3/4 on 2/25. Analysts were furious over having been lied to. Alex. Brown analyst Ryan wrote:

> * Management credibility has been severely damaged by this announcement, particularly in light of recent investor conference presentations exuding confidence on the Company's fundamentals. . . .
>
> * * *
>
> Our confidence in management and their credibility with us has been greatly diminished.

> As recently as one month ago, we reviewed our model with the Company line by line and were guided to higher Ceclor CD estimates. In our opinion, not too much could have changed between now and then, and we believe that this revenue shortfall is not new news to Dura, but frankly, comes as a surprise to us.

135. During the balance of 1998, Dura's business performed miserably. In a 4/16/98 conference call with analysts, Dura ***admitted*** that, at least by 12/97, the wholesale channels had been clogged with many months of excess inventory. Dura also revealed that sales of its Keftab, Dura-Vent and Rondec products were plummeting – so much so that by mid-98 Dura was forced to begin to create a new entity, DJ Pharma, Inc., to acquire these drugs so Dura would not be burdened with their losses. Dura also admitted its sales force was inadequate and had been plagued by very high turnover and that this was contributing to the poor sales of its drug products. On 10/5/98, analyst Ryan wrote:

> There was excessive inventory buildup in Ceclor CD among wholesalers in late 1997, and the Company asserts that this hurt 1998 sales. Management believes that the buildup has decreased, with inventory levels now down to one month's supply (versus five months earlier in the year). . . .

136. On 11/3/98, Dura revealed that the FDA had rejected the Albuterol Spiros NDA because the Spiros device was not reliable because of its unacceptably high failure rate

and because Dura had provided insufficient data to demonstrate Albuterol's stability. In other words, the FDA rejected the Albuterol Spiros NDA for the same reasons set forth in the Eisele List in 10/96, revealed during Dura's in-house stability testing completed before clinical trials, revealed during clinical trials, and identified by the FDA in the 5/97 pre-filing meeting, which prompted defendant Prettyman to urge that the NDA not be filed in the late 10/97, right before it was actually submitted. The FDA requested additional clinical trials on the Spiros inhaler in order to ensure inhaler reliability and replicate the clinical outcomes of the initial trials. The FDA also requested the resolution of a number of chemistry, manufacturing and control issues. Dura claimed that the FDA's letter raised no issues on the clinical data with the inhaler filed in the NDA demonstrating therapeutic comparability of Albuterol Spiros with Ventolin® (albuterol) MDI using standard lung function measures. But then, on 11/6/98 – just three days later – the FDA issued a "notice of violation" to Dura. "[T]he Division of Drug Marketing, Advertising and Communications (DDMAC) . . . found that Dura's press release sent a message that 'misleadingly minimizes the fact that Dura must conduct a completely new clinical data [study]. . . .'" Upon receiving the FDA letter, Dura removed the press release from its Web site. Ultimately, Dura completely abandoned the development of the Spiros device for use with Albuterol because Dura could never demonstrate that drug's stability.

Appendix C

DURA'S FALSE FINANCIAL REPORTING DURING THE CLASS PERIOD

137. In order to overstate its earnings for the interim quarters and year-end 1997, Dura violated Generally Accepted Accounting Principles ("GAAP") and SEC rules by failing to properly report the value of its investment in its Rondec product.

138. Dura reported the following financial results during the Class Period:

	Qtr-end 3/31/97	Qtr-end 6/30/97	Qtr-end 9/30/97	Qtr-end 12/31/97	Year 12/31/97
Revenues	$40.9 M	$43.6 M	$43.3 M	$53.5 M	$181.3 M
Net Income	$ 8.8 M	$ 9.2 M	$11.2 M	$18.0 M*	$ 47.4 M*
EPS	$.19	$.20	$.24	$.37*	$.99*

* Excluding one-time charge

139. Dura included its results for Q1, Q2 and Q3 1997 in Form 10-Qs which were filed with the SEC. The Form 10-Qs, signed by Newman, represented that the financial statements included all adjustments which are, "in the opinion of management, necessary for fair presentation."

140. These financial statements and the statements about them were false and misleading, as such financial information was not prepared in conformity with GAAP, nor was the financial information "a fair presentation" of the Company's

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operations due to the Company's improper accounting for its investment in Rondec, in violation of GAAP and SEC rules.

141. GAAP are those principles recognized by the accounting profession as the conventions, rules and procedures necessary to define accepted accounting practice at a particular time. Regulation S-X (17 C.F.R. §210.4-01(a)(1)) states that financial statements filed with the SEC which are not prepared in compliance with GAAP are presumed to be misleading and inaccurate. Regulation S-X requires that interim financial statements must also comply with GAAP, with the exception that interim financial statements need not include disclosure which would be duplicative of disclosures accompanying annual financial statements. 17 C.F.R. §210.10-01(a).

142. Dura had acquired the rights to the Rondec product line (prescription cough/cold drugs) from Abbott Laboratories on 6/30/95, making an investment in the product of more than $35 million. Dura selected an amortization period for this investment of 25 years. During the Class Period, sales of this product were extremely disappointing and not nearly enough to justify the investment. Nonetheless, in order to avoid an adverse impact on Dura's earnings, the defendants caused the Company not to write down the value of this investment, nor to even accelerate the amortization of this asset, in violation of GAAP.

143. GAAP, as set forth in FASB Statement of Financial Accounting Standard ("SFAS") No. 121, Accounting for the Impairment of Long-Lived Assets, requires that entities

evaluate the recoverability of long-lived assets to determine whether an asset is impaired. Where impairment is demonstrated, a loss shall be recorded to reflect the impairment. *See* SFAS No. 121, ¶¶4-11.

144. During the Class Period, Dura focused its sales efforts on Ceclor CD and Keftab, to the detriment of Rondec, sales of which were extremely disappointing and lagged well behind other products. Dura was required, pursuant to GAAP, to continually evaluate the carrying value of unamortized balances of intangible assets. In fact, in both its 1996 and 1997 financial statements, the Company represented that it did so. If Dura actually did evaluate the carrying amount of its investment in Rondec, it would have seen that the carrying balance of this asset was not justified by the revenue being generated by it. However, in order to report favorable earnings, Dura failed, in violation of GAAP, to record any impairment charge for this investment. Dura also failed even to accelerate (shorten the amortization period) the amortization of this asset which was amortized over an extremely long period, 25 years, for a prescription drug.

145. Ultimately, Dura could not ignore how poorly Rondec was selling in relation to the investment shown on the Company's balance sheet. In order to avoid taking a write-off, in 7/98, Dura formed an affiliate company (DJ Pharma) to co-promote Rondec, partially with money provided by Dura. As a result, the valuation of Rondec was not (at least temporarily) Dura's problem, as it was on the books of DJ Pharma. In 12/98, however, when the DJ Pharma transaction had not yet finalized, Dura was forced to reconsolidate DJ Pharma back into Dura. Finally, Dura acknowledged what

its insiders had known for at least 18 months: the Rondec investment was severely impaired. Dura has now taken a $28 million charge for the impairment of Rondec. This charge represents over a third of all the net income (excluding special charges) Dura reported during the Class Period.

146. Further, the undisclosed adverse information concealed by defendants during the Class Period is the type of information which, because of SEC regulations, regulations of the national stock exchanges and customary business practice, is expected by investors and securities analysts to be disclosed and is known by corporate officials and their legal and financial advisors to be the type of information which is expected to be and must be disclosed.

DEFENDANTS' SCIENTER

147. Each defendant is liable for making false statements or for failing to disclose adverse facts while selling Dura stock and/or for participating in a scheme which operated as a fraud or deceit on purchasers of Dura stock. Each defendant knowingly made false and misleading statements or participated in a fraudulent scheme and course of business that operated as a fraud on purchasers of Dura stock and damaged class members and/or sold Dura stock while concealing material adverse information.

148. The Individual Defendants, because of their positions as high-ranking officers and/or directors with the Company, possessed the power and authority to control the contents of Dura's quarterly and annual reports, SEC filings, press releases and presentations to securities analysts, money

and portfolio managers and institutional investors, *i.e.*, the market. Each Individual Defendant participated in drafting and was provided with copies of the Company's reports, SEC filings and press releases alleged herein to be misleading prior to or shortly after their issuance and had the ability and opportunity to prevent their issuance or cause them to be corrected. Because of their positions and access to material non-public information available to them but not to the public, each of these defendants knew that the adverse facts specified herein had not been disclosed to and were being concealed from the public and that the positive representations which were being made were then materially false and misleading. Despite their duty not to sell their Dura stock under such circumstances, defendants nonetheless did so. The Individual Defendants are liable for the false statements pleaded herein, as those statements were each "group-published" information, the result of the collective action of the Individual Defendants.

149. As the top officers and/or directors of Dura, defendants controlled the dissemination of, and could thereby falsify, information about Dura's business and finances which reached the investing public and affected the price of Dura's stock. Also, their insider corporate positions gave them knowledge about Dura's business that was not public – creating the opportunity for them to make false public statements, artificially inflate Dura's stock price and take advantage of their non-public information by using their corporate positions at Dura.

150. After reaching the all-time high price of $47-7/8 on 12/31/96, Dura stock declined sharply, falling to $27-7/8

on 4/14/97. This decline was due to concern over the ability of Dura's new Ceclor CD/Keftab drugs to continue to drive Dura's EPS growth and the ability of Dura to successfully introduce Albuterol Spiros by late 1998 or early 1999. This decline created tremendous problems for Dura's executives. By early 1997, they were already taking steps to complete a major convertible debt offering for Dura. They also knew during 1997 that Spiros I would exhaust its existing resources and that Dura would have to exercise its option to repurchase Spiros I stock and finance a new follow-on Spiros II entity to continue to pay for the development of the Spiros drug delivery system. The creation of a new Spiros II entity would require a public offering of securities that included warrants to buy Dura stock. Also, the value of the Dura insiders' existing stock options to purchase Dura stock at $29.63-$37.63 per share had been completely wiped out by the 1997 stock decline, and the value of the insiders' other options was greatly reduced. Finally, the yearly cash bonuses of Dura's top executives – which could amount to 100% of their base salaries – were dependent upon Dura's reported EPS and stock price performance. For all of these reasons, it was imperative to Dura's insiders that they drive Dura's stock price higher to enable Dura to raise needed capital, to exercise Dura's option to purchase Spiros I's stock by issuing as few shares as possible, to successfully complete a public offering of Spiros II securities, to restore the value of their stock options so that they could unload millions of dollars of the Dura stock they owned before the stock collapsed, and to allow them to be paid large year-end 1997 cash bonuses based on Dura's 1997 EPS and a strong 1997 stock performance.

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151. Thus, in 4/97 as Dura stock fell to as low as $27-7/8, the defendants repriced thousands of their $37.63 per share options – to just $25 per share – as follows: Garner 150,000 options, Brown 40,000 options, Newman 40,000 options, Prettyman 35,000 options, Spath 40,000 options, and Woodbury 30,000 options. Defendants also commenced a concerted publicity campaign to persuade investors that Dura's portfolio of older drug products was still selling very well, that Ceclor CD/Keftab were doing even better in the marketplace than had been anticipated and that Dura was successfully completing the development and clinical trials of its Albuterol Spiros product, such that it would likely result in that product reaching the market by late 1998/early 1999, generating millions of dollars of revenue and profits for Dura.

152. Dura's executive compensation structure also provided an additional motive for the Individual Defendants to participate in the fraud. Defendants' 1996-1997 cash bonuses, based on achieving EPS growth targets, are shown below:

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153. Defendants' fraudulent scheme was a success – for them. The Individual Defendants also sold 390,374 shares of their Dura stock at artificially inflated prices, pocketing $16.8 million in illegal insider-trading proceeds. Dura and its Spiros entities raised over $375 million by selling securities to the public and Dura was able to exercise its option to repurchase Spiros I stock for Dura stock at inflated prices.

INSIDER SELLING

154. While Dura's top insiders were issuing favorable statements about Dura, the Individual Defendants sold 386,233 shares of Dura stock, for more than $16.6 million – 82% of their collective holdings of Dura stock – to personally profit from the artificial inflation in Dura's stock price. Notwithstanding their access to material non-public information and their duty to disclose same before trading in Dura stock, they sold significant amounts of their Dura stock at artificially inflated prices at highly suspicious times. Defendants' selling occurred shortly after the pre-filing meeting with the FDA in 5/97 as insiders sold 188,626 shares for proceeds exceeding $7.3 million between 5/12/97 and 7/22/97. Defendants' massive bailout continued at the same time Dura was filing the Spiros device NDA, when the stock was at an all-time high, as defendants sold 197,607 shares for proceeds exceeding $9.2 million between 11/3/97 and 1/6/98. The later selling is highly suspicious given the internal disagreement between defendants themselves whether to even file the NDA. For example, after telling defendant Garner and other senior executives that he was against filing the NDA because there was insufficient data to obtain FDA approval, defendant Prettyman nonetheless sold 15,000 shares on 11/5/97 for $728,100 in proceeds. Defendants' insider selling during the Class Period is detailed below:

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155. Defendants' insider trading occurred during a time period when Dura was supposedly enjoying a period of exceptional business success and was poised to achieve strong revenue, net income and EPS growth, not only in the next quarter or two, but during the next few years at least. As a result, if these exceptionally favorable present conditions and future prospects actually existed, Dura stock should have been poised for a major advance over the next few years as was being predicted by several prominent investment firms that followed Dura and whose analysts were relying upon the information provided them by the Individual Defendants. Nevertheless, the Individual Defendants unloaded 386,233 shares of Dura stock for $16.6 million in illegal insider-trading proceeds at the beginning or during the early stages of this supposed exceptionally favorable period. The Individual Defendants did this because they knew their statements about the current strong condition of and successes with Dura's business, as well as its strong future prospects, ***were false*** and they were concealing the serious negative conditions in Dura's business detailed herein. By selling off the large amounts of Dura stock when they did, the Individual Defendants not only personally profited from the artificial inflation in the price of Dura stock that their false and misleading statements and manipulations had created, but they also avoided losing millions when the stock declined.

Name and Principal Position	Year	Annual Compensation Salary	Bonus
Cam L. Garner	1997	$396,519	$475,000
Chairman, President & CEO	1996	$347,654	$610,000
Walter F. Spath	1997	$210,808	$140,000
Senior VP-Sales & Marketing	1996	$201,538	$190,000
James W. Newman	1997	$200,769	$140,000
Senior VP-Finance & Administration & CFO	1996	$190,039	$190,000
Charles W. Prettyman	1997	$191,116	$140,000
Senior VP-Development & Regulatory Affairs	1996	$179,577	$190,000

NAME	DATE SOLD	SHARES SOLD	PRICE PER SHARE	PROCEEDS FROM SALE
Brown	05/21/97	39,383	$40.21	$1,583,590
		39,383		$1,583,590
Cook	05/23/97	20,000	$42.00	$ 840,000
	01/06/98	5,000	$47.06	235,300
	01/06/98	10,000	$47.00	470,000
	01/06/98	5,000	$47.13	235,650
		40,000		$1,780,950
Garner	05/12/97	60,000	$36.64	$2,198,400
	05/19/97	6,623	$38.75	256,641
	05/19/97	1,000	$38.75	38,750
	05/30/97	30,000	$39.76	1,192,800
	11/03/97	30,000	$48.63	1,458,900
	11/04/97	17,000	$48.13	818,210
	11/05/97	10,000	$49.31	493,100
		154,623		$6,456,801

Newman	07/22/97	1,620	$41.88	$ 67,846
	11/14/97	500	$46.00	23,000
	11/24/97	500	$46.00	23,000
	12/05/97	31,700	$45.69	1,448,373
	12/09/97	17,907	$46.25	828,199
		52,227		$2,390,417
Prettyman	11/05/97	15,000	$48.54	$ 728,100
		15,000		$ 728,100
Spath	05/15/97	20,000	$39.03	$ 780,600
	05/16/97	10,000	$38.69	386,900
	11/18/97	20,000	$45.45	909,000
		50,000		$2,076,500
Woodbury	11/14/97	7,000	$46.24	323,680
	11/17/97	28,000	$45.70	1,279,600
		35,000		$1,603,280

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156. This insider selling by the Individual Defendants was highly unusual, both in its timing and in its amount. The defendants who exercised options on Dura stock during the Class Period each sold 100% or close to 100% of the stock they acquired by option exercise. These sales came just after the purported successful introduction of major new product lines by Dura (Ceclor CD/Nasalide) that were supposed to push its earnings higher for several quarters, and while the market was expecting FDA approval of Dura's new Albuterol Spiros product in 1998. While the Individual Defendants also owned vested stock options which were not exercised, their stock sales were still significant in amount and unusual in timing, even considering their options holdings. The table below summarizes defendants' insider selling comparing sales to stock actually owned and total holdings, including vested options:

Dura Pharmaceuticals, Inc.

Class Period: April 15, 1997 - February 24, 1998

Insider	Class Period Sales/ Distributions	Sales Proceeds	Percent of Stock Sold (1)	Percent of Total Holdings Sold (2)
Brown, Julia R	39,383	$1,583,590	100%	36%
Cook, Joseph C. Jr.	40,000	$1,780,950	43%	29%
Garner, Cam L.	154,623	$6,456,801	67%	62%
Newman, James W.	52,227	$2,390,417	78%	34%
Prettyman, Charles W.	15,000	$728,100	100%	46%
Spath, Walter F.	50,000	$2,076,500	100%	32%
Woodbury, Mitchell	35,000	$1,603,280	100%	31%
Total:	386,233	$16,619,638		

(1) Includes common stock and options exercised and sold during the Class Period.

(2) Includes common stock, options and warrants exercisable.

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BLACK-SCHOLES OPTIONS VALUATION AS EVIDENCE OF SCIENTER

157. An analysis of the timing of an insider's exercise of stock options and sale of the underlying shares can provide clear and convincing evidence that these transactions were either irrational or based on non-public information. The analysis is based on the common sense foundation that executives will not irrationally, and needlessly, waste large amounts of their wealth. If the finder of fact is unwilling to believe that financially sophisticated executives, privy to all of a company's non-public information, would engage in dramatically irrational personal financial decisions, then a strong inference can be drawn that transactions were based on non-public information, and therefore were illegal.

158. The analytical tool used here is the universally accepted method for calculating the value of stock options, named for its authors, Black and Scholes, who earned the Nobel Prize for this now well-established methodology.[1] Options are valuable rights because the option allows its owner to preserve the opportunity for upside gain without any capital commitment and without any risk of loss. The Black-Scholes formula calculates the expected market value of any option based on several factors: stock price; exercise price of the option; expiration date of the option; volatility of the stock; and the risk-free rate of return. At any time prior to its expiration date the market value of any option has two components: (1) "intrinsic value," the amount of money that one could obtain by exercising the option as of today (stock price less the strike or exercise price of the option); and (2) "time value," the value from any potential

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increase in the stock price during the term of the option. The formula demonstrates that a rational investor in an environment of efficient markets, relying solely upon public information, would not exercise an option to purchase a non-dividend paying stock prior to the expiration date of the option. The reason for this conclusion is that an early exercise of an option to purchase forfeits the time value of the option between the date of exercise and the date the option expires.

159. Holding the option to maturity maximizes the holder's wealth, assuming that the holder makes transactions based only on public information. The rational executive will never forfeit more than a *de minimis* amount of this value because it is unnecessary to do so. Any desire for asset liquidity or diversification can be achieved by any number of financial instruments readily available and commonly used by executives. For example, executives commonly protect themselves from risk by the use of put options, call options, zero cost collars, and equity swaps. All these instruments are readily available, are commonly used, and can be obtained by a simple phone call to a broker. Similarly, information regarding these options is readily available to these executives through financial advisors and is part of the course work involved in obtaining business degrees. Further, such instruments are commonly used by executives in performing their duties.

160. Should the holder of an executive option exercise these options early, the Black-Scholes formula quantifies the resulting loss to the executive. The premature exercise of vested options, and its associated dollar cost to the Individual Defendants (as calculated by the Black-Scholes formula), can

be explained as rational, *i.e.*, to maximize the returns on their asset only if the Individual Defendants were in possession of material adverse undisclosed inside information. Those Individual Defendants would be willing to forego the time value of the option because they know that the value is based upon an artificially inflated stock price – a price that does not yet reflect the non-public adverse information on which the executive is basing his or her decision to exercise and sell his or her stock.

161. The Black-Scholes option pricing formula is widely accepted and used. Studies of executive pay regularly use the Black-Scholes formula to estimate the value of executive stock options. For example, the Black-Scholes formula has served as the basis for the following studies and analyses:

- *Los Angeles Times's* executive pay study conducted by Watson Wyatt Worldwide used the Black-Scholes formula.

- The 2000 CFO Compensation Survey undertaken by the consulting firm Towers Perrin utilized the Black-Scholes formula to value executive options.

- *The Wall Street Journal's* CEO Compensation Survey, conducted by William M. Mercer, Inc., one of the nation's leading consulting organizations also used the Black-Scholes formula to calculate the value of stock options.

- This same method was used by Deloitte & Touche to rank CEO pay at Dallas-Fort Worth's 100 largest public companies.

- A general overview of executive options published by Harvard University Graduate School of Business Administration, entitled "What You Need to Know About Stock Options," notes that some executives receive stock options under a "Fixed Value Plan." Under such a plan executives receive options of a predetermined value every year over the life of the plan. As noted, the options are valued in such plans using "Black-Scholes or similar valuation formulas."

- The nation's ranking expert on executive compensation, Graef Crystal, has argued vigorously for many years that all United States companies should use the Black-Scholes formula in determining the expenses associated with executive stock options. Crystal argues that the failure by some companies has caused top executive pay to escalate wildly out of control.

162. As a result, the Black-Scholes formula often is used by corporations to value executive stock options. For example, Gateway Inc., Adaptec Inc. and 3COM Corp. have reported in their proxy statements that they all recently used the Black-Scholes formula for valuing executive options. All in all, 12% of technology companies and 44% of non-technology companies use the Black-Scholes formula to valuate their options.

163. The Black-Scholes formula also is used by executives to value their own stock options. For example, the employment agreement for Gateway Inc.'s CEO Jeffrey Weitzen requires Gateway to pay Mr. Weitzen option grants worth $4.9 million as calculated using the Black-Scholes formula:

> Recurring Options. Commencing in calendar year 2000 and thereafter in each calendar year during the Employment Period, ***the Company will recommend to the Compensation Committee that the Executive receive, twice annually in accordance with the terms of the Plan (or any replacement plan therefor), an option grant (calculated using the Black Scholes formula of option pricing) that would be equivalent to a Black Scholes value of $4,876,000.*** For example, using the Black Scholes formula, if the stock price of Gateway common stock was $50/share at the time of the grant, the Executive would receive 160,026 shares of Gateway common stock ($4,876,000 divided by $30.47 being the Black Scholes value at $50/share, which equals 160,026 shares of stock).

Hence, such a formula is a necessity for executives to valuate accurately their own employment pay packages.

164. Using Black-Scholes in this case reveals that defendants exercised their options in a way which demonstrates their use and possession of inside, non-public information. As set forth above, the Individual Defendants

knew of facts that would result in Dura's financial results falling far short of the levels being forecasted. The defendants knew that the Company's failure to meet these forecasts would dramatically lower the price of Dura stock. Thus, defendants determined, based upon non-public, inside information, that exercising many of their options prior to the disclosure of the adverse, inside information would provide returns greater than holding the options beyond the time of disclosure of the adverse inside information. As a result, defendants prematurely exercised a vast number of employee stock options which no rational executive would have exercised absent knowledge of impending doom.

165. For example, on 11/5/97, Prettyman prematurely exercised options for 2,057 shares – options that would have expired more than nine years later. The total risk-adjusted value of these options on that day was $79,084. That is, were one to attempt to purchase such options at an options exchange or in an over-the-counter transaction, one would have paid approximately $79,084 to obtain options with rights similar to those held by Prettyman, and this value would be set based upon the information available to the public on that day. Nevertheless, Prettyman prematurely exercised his options and obtained only $48,422. Absent Prettyman's possession and use of inside information, Prettyman's transaction makes no rational sense, as he forfeited $30,663 of value by this early exercise.[2]

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2. The source of information for all of the calculations in this section are defendants' own Proxy Statements, Forms 3, 4, 5, and 144's filed with the SEC, publicly available risk-free interest rate data, publicly available volatility calculations for Dura stock, and publicly available Dura price data.

166. In contrast, Prettyman's otherwise irrational act is clearly rational when viewed as one based on inside information. The options that were valued using public information at $79,084 on the day he exercised the options (on 11/5/97), declined precipitously to $36,259[3] after the bad news was revealed (on 2/25/98). Hence, Prettyman's exercising of options, was, in fact, rational only if Prettyman used inside information. Indeed, Prettyman's use of inside information led him to realize more than a $12,000 profit over what he would have obtained had he held onto his options. Such trading is clearly suspicious and is designed to "'maximize the personal benefit from undisclosed inside information.'" *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 986-87 (9th Cir.1999) (quoting *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1117 (9th Cir. 1989)).

167. An analysis of some of defendants' other exercises of options reveals a similar pattern. As detailed below, numerous option exercises by defendants during the Class Period, when evaluated using publically available information, were irrational if based on publicly available information – because they constituted a sale of the options for only $0.60-$0.85 per dollar of actual worth:

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3. This number is the maximum value of the option - using the favorable 100-day volatility value on 2/25/98.

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Date	Number of Options	Options Value	Actual Proceeds	Wealth Lost by Early Exercise	Options Dumped for No. of Cents on the Dollar
Brown:					
11/05/05	8759	$310,374	$230,099	$80,475	74.1¢
Garner:					
11/3/97	7725	303,996	225,956	77,930	74.4¢
11/3/97	29,440	1,215,666	1,021,274	194,393	84¢
Newman:					
12/5/97	6291	226,141	165,516	60,625	73.2¢
12/5/97	9409	358,055	298,736	59,319	83.4¢
Prettyman:					
11/5/97	2,932	$93,476	$78,473	$15,003	$1.839
11/5/97	3,150	$123,669	$91,854	$31,815	74.3¢
11/5/97	2,057	$79,084	$48,422	$30,663	61.2¢
Woodbury:					
02/19/99	20,000	$352,820	$266,250	$86,570	75.5¢
Smith:					
11/14/97	4,269	$163,649	$136,644	$27,604	83.1¢

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168. Using the Black-Scholes equation we can ***also*** analyze those options which defendants ***did not*** exercise. For example, on 2/24/98 (the last day of the Class Period) defendants chose ***not*** to exercise any options. In particular, Garner did exercise his option to purchase 45,719 shares at a strike price of $37.63. However, the fact that Garner chose ***not*** to exercise these options in no way defeats scienter in this case. In particular, the value of these options on that day was $1,112,058. ***Had he exercised and sold these options he would have obtained only $22,860, a loss of 97.94% in the value of these options.*** No rational investor, basing his decision only on public information, could be expected to conduct his affairs in this manner. Further, Garner's decision ***not*** to exercise this option makes sense ***even if he had based his decision on the insider information as the value of the options after the bad news was revealed was $761,558 or almost $740,000 more than he would have obtained by early exercise.*** Because no executive would ever exercise such an option under these circumstances, this option was not in any informative way part of Garner's holdings available for sale.

169. As a boundary, it is reasonable to expect that a lawful rational executive would never exercise an option in which he or she would incur greater than a 20% loss. Removing such irrational option exercises from defendants' "available holdings" demonstrates that defendants held on to very few rationally exercisable options:

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170. Removing such irrational option exercises from defendants' "available holdings" demonstrates that defendants sold a tremendous amount of their truly ***available*** holdings.

Defendant	**% of Actual Available Holdings Sold**
Brown	47.01%
Garner	94.35%
Newman	44.52%
Prettyman	100.00%
Spath	42.68%

SAFE HARBOR

171. The safe harbor provided for forward-looking statements ("FLS") does not apply to the false FLS pleaded. The safe harbor does not apply to Dura's allegedly false financial statements. None of the FLS pleaded herein were identified as "forward-looking statements" when made, it was not stated that actual results "could differ materially from those projected," nor did meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the FLS accompany those FLS. None of the historic or present-tense statements made by defendants were assumptions underlying or relating to any plan, projection or statement of future economic performance, as they were not stated to be such assumptions underlying or relating to any projection or statement of future economic performance when made nor were any of the projections or forecasts made by defendants expressly related to or stated to be dependent on those historic or present-tense statements when made.

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CLASS ACTION ALLEGATIONS

172. This is a class action on behalf of those persons who purchased Dura securities between 4/15/97 and 2/24/98 (the "Class"), and were harmed thereby. Class members are so numerous that joinder of them is impracticable.

173. Excluded from the Class are: (i) defendants; (ii) members of the families of each Individual Defendant; (iii) any entity in which any defendant has a controlling interest; (iv) officers and directors of Dura and its subsidiaries and affiliates; and (v) the legal representatives, heirs, successors or assigns of any such excluded party.

174. Throughout the Class Period, shares of Dura common stock were actively traded on the NASDAQ National Market System, which is an efficient market. The members of the Class, as purchasers on that market, are so numerous that joinder of all members is impracticable. As of 2/24/98, approximately 46 million shares of Dura common stock were outstanding.

175. Common questions of law and fact predominate and include whether defendants: (i) violated the 1934 Act; (ii) omitted and/or misrepresented material facts; (iii) knew or recklessly disregarded that their statements were false; (iv) artificially inflated Dura's stock price; and (v) the extent of and appropriate measure of damages.

176. Lead Plaintiffs' claims are typical of those of the Class. Prosecution of individual actions would create a risk of inconsistent adjudications. Plaintiffs will adequately

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protect the interests of the Class. A class action is superior to other available methods for the fair and efficient adjudication of this controversy. Because the damages suffered by individual Class members may be relatively small, the expense and burden of individual litigation make it virtually impossible for Class members individually to seek redress for the wrongful conduct alleged herein.

177. The names and addresses of the record owners of Dura securities purchased or acquired during the Class Period are available from the Company's transfer agent(s). Notice may be provided to such record owners via first class mail using techniques and a form of notice similar to those customarily used in class actions.

FIRST CLAIM FOR RELIEF

178. Defendants violated §10(b) and Rule 10b-5 by:

(a) Employing devices, schemes and artifices to defraud;

(b) Making untrue statements of material facts and omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and

(c) Engaging in acts, practices and a course of business that operated as a fraud or deceit upon the Class in connection with their purchases of Dura securities.

179. Class members were damaged. In reliance on the integrity of the market, they paid artificially inflated prices for Dura securities.

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SECOND CLAIM FOR RELIEF

For Violation Of Section 20(a) Of The 1934 Act Against Defendants Garner, Spath and Newman

180. Plaintiffs incorporate ¶¶1-179. Plaintiffs assert this claim against Garner, Spath and Newman. These defendants acted as controlling persons of Dura and the other Individual Defendants within the meaning of §20 of the 1934 Act as alleged herein. By virtue of their executive and directorial positions, their knowledge and involvement in the day-to-day business of Dura, including its financial reporting and research and development, their stock ownership, and their power and ability to make public statements on behalf of Dura to shareholders, potential investors and the media, these defendants had the power and ability to control the actions of Dura and the other Individual Defendants.

181. By reasons of their wrongful conduct, defendants Garner, Spath and Newman are liable pursuant to §20(a) of the 1934 Act. As a direct and proximate result of these defendants' wrongful conduct, plaintiffs and the other members of the Class suffered damages in connection with their purchases of the Company's securities during the Class Period.

PRAYER

WHEREFORE, plaintiffs pray for judgment, declaring this action to be a proper class action; awarding damages, including interest; and such equitable/injunctive or other relief as the Court may deem proper.

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JURY DEMAND

Plaintiffs demand a trial by jury.

DATED: September 23, 2000

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APPENDIX D — DEFENDANTS' REQUEST FOR JUDICIAL NOTICE IN SUPPORT OF MOTION TO DISMISS PLAINTIFFS' SECOND CONSOLIDATED AND AMENDED COMPLAINT WITH EXHIBITS DATED AND FILED NOVEMBER 22, 2000

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

Master File No. 99 CV 0151 JL JFS

CLASS ACTION

In re DURA PHARMACEUTICALS, INC. SECURITIES LITIGATION

This Document Related To:

All Actions.

DEFENDANTS' REQUEST FOR JUDICIAL NOTICE IN SUPPORT OF MOTION TO DISMISS PLAINTIFFS' SECOND CONSOLIDATED AND AMENDED COMPLAINT

[Fed. R. Civ. Proc. 12(b)(6), 9(b);
Priv. Secur. Litig. Ref. Act of 1995]

Date: March 12, 2001
Time: 10:30 a.m.
Ctrm: 11

The Honorable M. James Lorenz

Appendix D

1. Defendants Dura Pharmaceuticals, Inc. ("Dura"), Cam L. Garner, James W. Newman, Charles W. Prettyman, Walter F. Spath, Julia R. Brown, Joseph C. Cook, Jr. and Mitchell R. Woodbury (collectively, "Defendants") hereby request, pursuant to Rule 201 of the Federal Rules of Evidence, that this Court take judicial notice of the following court orders, public filings and other documents. True and correct copies of these documents are attached to this Request for Judicial Notice as Exhibits A through AC in support of Defendants' Motion to Dismiss Plaintiffs' Second Consolidated and Amended Complaint ("SAC"), filed concurrently herewith.

EXHIBIT NUMBER	DOCUMENT
A	Chart comparing alleged omissions and Dura's risk disclosures, excerpted from Dura's SEC filings;
B	United States House of Representatives Conference Report No. 104-369, 104th Cong., 1st Sess. 31 (1995);
C	Dura's Schedule 14A Information (Proxy Statement) filed with the U.S. Securities and Exchange Commission ("SEC") on April 16, 1997;
D	Dura's Schedule 14A Information (Proxy Statement) filed with the SEC on April 16, 1998;

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No. of	Option Value	Proceeds	Wealth Lost	Penny Per Dollar Obtained If Sold
Brown:				
12192	$296,555	$6,096	$290,459	2.1¢
14036	$429,693	$339,531	$90,162	79.0¢
Garner:				
2330	$66,797	$43,688	$23,109	65.4¢
45719	$1,112,058	$22,860	$1,089,199	2.1¢
31326	$872,876	$411,310	$461,566	47.1¢
Newman:				
12192	$296,555	$6,096	$290,459	2.1¢
3764	$107,907	$70,575	$37,332	65.4¢
8356	$232,834	$109,714	$123,120	47.1¢
19084	$584,231	$461,642	$122,589	79.0¢

Prettyman:				
6280	$192,254	$151,913	$40,340	79.0¢
6905	$197,953	$129,469	$68,485	65.4¢
12192	$296,555	$6,096	$290,459	2.1¢
5255	$146,427	$68,998	$77,429	47.1¢
Spath:				
17096	$523,371	$413,552	$109,819	79.0¢
12192	$296,555	$6,096	$290,459	2.1¢
8356	$232,834	$109,714	$123,120	47.1¢

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E Statements of Changes in Beneficial Ownership (Forms 4 and 5) reported and filed with the SEC by Defendant Cam L. Garner;

F Statements of Changes in Beneficial Ownership (Forms 4 and 5) reported and filed with the SEC by Defendant James W. Newman;

G Statements of Changes in Beneficial Ownership (Forms 4 and 5) reported and filed with the SEC by Defendant Charles W. Prettyman;

H Statements of Changes in Beneficial Ownership (Forms 4 and 5) reported and filed with the SEC by Defendant Walter F. Spath;

I Statements of Changes in Beneficial Ownership (Forms 4 and 5) reported and filed with the SEC by Defendant Julia R. Brown;

J Statements of Changes in Beneficial Ownership (Forms 4 and 5) reported and filed with the SEC by Defendant Joseph C. Cook, Jr.;

K Statements of Changes in Beneficial Ownership (Forms 4 and 5) reported and filed with the SEC by Defendant Mitchell R. Woodbury;

L Daily Closing Price History for Dura's Common Stock, as reported by the NASDAQ National Market System, for the period of November 21, 1994 through November 18, 1999;

Appendix D

M Dura's Form 10-K filed with the SEC on March 31, 1997 for the fiscal year ended December 31, 1996;

N Dura's Form 10-K filed with the SEC on March 31, 1998 for the fiscal year ended December 31, 1997;

O Dura's Form 10-Q filed with the SEC on May 14, 1997 for the quarter ending March 31, 1997;

P Dura's Form 10-Q filed with the SEC on July 15, 1997 for the quarter ending June 30, 1997;

Q Dura's Form S-1 Registration Statement filed with the SEC on October 10, 1997.

R Dura's Form 10-Q filed with the SEC on October 21, 1997 for the quarter ending September 30, 1997;

S Dura's Press Release dated April 15, 1997 (SAC ¶ 56);

T Dura's Press Release dated May 7, 1997 (SAC ¶ 74);

U Dura's Press Release dated June 5, 1997 (SAC ¶ 79);

V Dura's Press Release dated July 15, 1997 (SAC ¶ 85);

W Dura's Press Release dated October 10, 1997 (SAC ¶ 107);

X Dura's Press Release dated October 14, 1997 (SAC ¶ 111);

Y Dura's Press Release dated November 10, 1997 (SAC ¶ 123);

Z Dura's Press Release dated January 20, 1998 (SAC ¶ 128);

AA Dura's Press Release dated February 24, 1998 (SAC ¶ 134);

AB Dura's Press Release dated November 4, 1998 (SAC ¶ 135); and

AC Dura's Prospectus filed with the SEC on November 13, 1996.

2. Judicial notice under Rule 201 of the Federal Rules of Evidence is appropriate for these legislative history materials concerning the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), public records, and documents referenced or cited in the complaint. *See, e.g.*, this Court's Order in this matter Granting Defendants' Motion to Dismiss Without Prejudice dated July 11, 2000, at 9-10; *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 986-87 (9th Cir. 1999) (on motion to dismiss court may take judicial notice of and consider public disclosure documents required by law to be filed and actually filed with the SEC, including

Form 4's and other documents evidencing defendants' stock trading history); *Kramer v. Time Warner*, 937 F.2d 767, 774 (2d Cir. 1991) (on motion to dismiss court may take judicial notice of and consider public disclosure documents required by law to be filed and actually filed with the SEC); *Ronconi v. Larkin* [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,212, at 90,887 (N.D. Cal. May 1, 1998) ("court can also take judicial notice of the relevant public disclosure documents filed with the [SEC], the full text of documents cited by plaintiffs in their complaint, and documents whose contents are alleged in the complaint and whose accuracy is not in dispute"); *cf. Branch v. Tunnell*, 14 F.3d 449, 454 (9th Cir.), *cert. denied*, 512 U.S. 1219, 114 S. Ct. 2704 (1994) (documents whose contents are alleged in a complaint may be considered in a motion to dismiss).

DATED: November 22, 2000

BROBECK, PHLEGER & HARRISON LLP

By: s/ Sean T. Prosser
Sean T. Prosser
Attorneys for Defendants

Appendix D

EXHIBIT L

DURA - Common Stock
Stock Price History

Date	Close	Volume (00s)
11/18/1999	13.563	7480
11/17/1999	13.688	3374
11/16/1999	13.438	4095
11/15/1999	13.125	1670
11/12/1999	13.188	1630
11/11/1399	13.000	5778
11/10/1999	12.625	3649
11/09/1999	12.500	3916
11/08/1999	13.000	2172
11/05/1999	12.938	3875
11/04/1999	12.750	1268
11/03/1999	12.500	1951
11/02/1999	12.250	3844
11/01/1999	12.125	2262
10/29/1999	12.781	1559
10/28/1999	12.875	1309
10/27/1999	12.438	2230
10/26/1999	12.719	2082
10/25/1999	12.938	2973
10/22/1999	13.063	2687
10/21/1999	13.063	3672
10/20/1999	12.875	5055
10/19/1999	12.875	4403
10/18/1999	12.469	2434
10/15/1999	12.875	5020

Appendix D

Date	Close	Volume (00s)
10/14/1999	13.438	3757
10/13/1999	13.438	3475
10/12/1999	13.563	2346
10/11/1999	13.500	2345
10/08/1999	13.438	2856
10/07/1999	13.813	9701
10/06/1999	13.688	5965
10/05/1999	13.531	6773
10/04/1999	13.813	2209
10/01/1999	13.500	5731
09/30/1999	13.938	5177
09/29/1999	13.188	3763
09/28/1999	13.125	4481
09/27/1999	13.250	2658
09/24/1999	12.875	3203
09/23/1999	13.063	8982
09/22/1999	13.688	3501
09/21/1999	13.500	3224
09/20/1999	13.563	3273
09/17/1999	13.500	5696
09/16/1999	13.500	3260
09/15/1999	13.656	3699
09/14/1999	13.188	4341
09/13/1999	13.875	5291
09/10/1399	13.250	1594
09/09/1999	13.250	1771
09/09/1999	13.250	2534
09/07/1999	13.375	5031
09/03/1999	13.875	5041
09/02/1993	13.000	2760

Appendix D

Date	Close	Volume (00s)
09/01/1999	13.188	2359
08/31/1999	13.313	4575
08/30/1999	13.375	15274
08/27/1999	14.500	24895
08/26/1999	13.875	8048
08/23/1999	13.375	8204
08/24/1999	12.875	6149
08/23/1999	12.875	9567
08/20/1999	12.500	5097
08/19/1999	12.094	7130
08/18/1999	12.188	5997
08/17/1999	11.875	7429
08/16/1999	11.000	4007
08/13/1999	10.500	7090
08/12/1999	10.313	2207
08/11/1999	10.250	4666
08/10/1999	10.250	2940
08/09/1999	10.313	13548
08/06/1999	10.250	2139
08/05/1999	10.375	2106
08/04/1999	10.375	5742
08/03/1999	10.750	12427
08/02/1999	10.563	2846
07/30/1999	10.438	6535
07/29/1999	10.250	3663
07/28/1999	10.250	4481
07/27/1999	10.000	8067
07/26/1999	10.000	8686
07/23/1999	9.953	7005
07/22/1999	10.000	6669

Appendix D

Date	Close	Volume (00s)
07/21/1999	10.125	5243
07/20/1999	10.438	5001
07/19/1999	10.313	11324
07/16/1999	10.813	5838
07/15/1999	11.063	7357
07/14/1999	10.875	2430
07/13/1999	10.906	2558
07/12/1999	11.000	5360
07/09/1999	11.500	8576
07/08/1999	11.188	3067
07/07/1999	10.969	4755
07/06/1999	11.188	3721
07/02/1999	11.438	2799
07/01/1999	11.688	3266
06/30/1999	11.938	5768
06/29/1999	11.063	1566
06/28/1999	11.188	2095
06/25/1999	11.125	2215
06/24/1999	11.250	2303
06/23/1999	11.375	2674
06/22/1999	11.500	4215
06/21/1999	11.250	3127
06/18/1999	11.438	2851
06/17/1999	11.500	2525
06/16/1999	11.375	5036
06/15/1999	10.688	2322
06/14/1999	10.563	3380
06/11/1999	10.813	1974
06/10/1999	10.750	4790
06/09/1999	11.000	9132

Appendix D

Date	Close	Volume (00s)
06/08/1999	10.500	7616
06/07/1999	10.281	3121
06/04/1999	10.281	7581
06/03/1999	10.500	6059
06/02/1999	10.250	3872
06/01/1999	10.563	8721
05/28/1999	10.375	7802
05/27/1999	10.188	4704
05/26/1999	10.625	4468
05/25/1999	11.000	3215
05/24/.1999	11.500	2262
05/21/1999	11.875	4939
05/20/1999	11.125	6443
05/19/i999	11.000	2024
05/18/1999	11.125	4721
05/17/1999	10.688	4315
05/14/1999	10.938	5194
05/13/1999	11.250	5049
05/12/1999	11.438	4238
05/11/1999	11.500	4564
05/10/1999	11.063	1751
05/07/1999	11.125	5729
05/06/1999	11.375	3125
05/05/1999	11.500	3134
05/04/1999	11.688	3261
05/03/1999	11.875	3154
04/30/1999	12.000	5446
04/29/1999	12.000	3268
04/28/1999	11.875	6979
04/27/1999	12.188	6626

Appendix D

Date	Close	Volume (00s)
04/26/1999	12.438	10039
04/23/1999	12.125	5138
04/22/1999	12.375	7824
04/21/1999	12.813	3546
04/20/1999	12.625	5229
04/19/1999	12.500	4707
04/16/1999	12.938	5635
04/15/1999	12.750	6091
04/14/1999	13.875	6426
04/13/1999	14.500	3983
04/12/1999	14.813	3915
04/09/1999	14.969	8838
04/08/1999	14.063	4158
04/07/1999	14.188	5016
04/06/1999	13.813	2802
04/05/1999	14.125	2984
04/01/1999	13.938	6167
03/31/1999	14.125	2509
03/30/1999	14.438	3413
03/29/1999	14.375	3465
03/26/1999	14.375	6516
03/25/1999	13.156	5495
03/24/1999	12.625	3479
03/23/1999	12.875	3357
03/22/1999	13.438	2946
03/19/1999	13.750	5649
03/18/1999	13.875	5637
03/17/1999	15.813	3033
03/16/1999	15.938	2625
03/15/1999	16.313	4600

Appendix D

Date	Close	Volume (00s)
03/12/1999	16.000	18375
03/11/1999	14.938	4058
03/10/1999	14.813	5761
03/09/1999	14.813	9551
03/08/1999	14.688	7809
03/05/1999	12.813	5546
03/04/1999	13.500	4026
03/03/1999	13.250	4345
03/02/1999	13.438	4594
03/01/1999	14.125	5304
02/26/1999	14.063	3412
02/25/1999	14.375	3413
02/24/1999	14.250	9946
02/23/1999	14.563	11641
02/22/1999	15.563	4987
02/19/1999	15.375	6903
02/18/1999	15.438	4510
02/17/1999	15.375	4159
02./16/1999	15.875	9162
02/12/1999	15.156	7619
02/11/1999	15.563	6894
02/10/1999	16.063	4278
02/09/1999	16.563	6759
02/08/1999	16.938	3013
02/05/1999	16.938	11190
02/04/1999	16.813	13851
02/03/1999	17.438	30328
02/02/1999	14.500	7388
02/01/1999	14.000	5225
02/29/1999	14.438	5806

Appendix D

Date	Close	Volume (00s)
01/28/1999	14.750	12805
01/27/1999	14.000	5694
01/26/1999	14.313	8448
01/25/1999	14.433	3558
01/22/1999	14.719	4049
01/21/1999	14.875	5123
01/20/1999	14.938	4092
01/19/1999	14.875	6190
01/15/1999	15.000	9958
01/14/1999	14.125	3814
01/13/1999	14.375	5276
01/12/1999	15.000	3855
01/11/1999	14.938	3193
01/08/1999	15.250	13414
01/07/1999	15.813	9069
01/06/1999	16.000	17175
01/05/1999	14.938	3719
01/04/1999	14.625	5979
12/31/1998	15.188	9550
12/30/1998	14.875	20239
12/29/1998	13.813	20118
12/28/1998	13.188	14232
12/24/1998	13.375	8965
12/23/1998	13.500	37357
12/22/1998	11.500	8495
12/21/1998	11.938	8363
12/18/1998	12.375	14432
12/17/1998	11.750	12856
12/16/1998	11.688	34640
12/15/1998	10.875	6410

Appendix D

Date	Close	Volume (00s)
12/14/1998	10.438	5045
12/11/1998	11.000	4387
12/10/1998	10.938	3477
12/09/1998	11.125	5044
12/08/1998	11.438	9244
12/07/1998	11.125	14954
12/04/1998	10.875	50356
12/03/1998	12.500	4089
12/02/1998	12.500	10030
12/01/1998	12.500	6006
11/30/1998	12.938	7125
11/27/1998	13.500	3711
11/25/1998	13.750	4059
11/24/1998	13.750	9765
11/23/1998	13.563	22471
11/20/1998	12.438	8891
11/19/1998	12.250	7223
11/19/1998	12.125	7069
11/17/1998	11.875	13270
11/16/1998	12.063	5924
11/13/1998	11.813	11694
11/12/1998	11.625	11985
11/11/1998	10.969	13987
11/10/1998	10.500	7389
11/09/1998	10.313	6841
11/06/1998	10.375	13807
11/05/1992	10.313	39209
11/04/1999	9.750	97966
11/03/1998	12.375	15353
11/02/1998	12.500	11925

Appendix D

Date	Close	Volume (00s)
10/30/1998	12.063	18410
10/29/1998	12.250	20186
10/29/1998	1.938	11253
10/27/1999	12.875	13407
10/26/1998	13.375	11886
10/23/1998	13.313	12608
10/22/1998	12.125	11901
10/21/1998	11.250	9669
10/20/1998	10.750	14524
10/19/1998	10.813	19713
10/16/1998	9.281	11051
10/15/1998	9.438	11294
10/14/1998	9.625	10481
10/13/1998	10.000	9964
10/12/1998	8.938	12810
10/09/1998	8.188	12263
10/08/1998	8.188	8309
10/07/1998	8.875	5303
10/06/1998	9.438	13989
10/05/1998	9.938	30156
10/02/1999	9.500	18609
10/01/1998	9.813	16129
09/30/1998	10.938	7563
09/29/1998	10.750	18015
09/28/1998	10.438	26706
09/25/1998	10.563	29767
09/24/1998	10.625	51022
09/23/1998	11.938	15353
09/22/1998	14.438	3974
09/21/1998	14.500	18268

Appendix D

Date	Close	Volume (00s)
09/18/1998	15.625	12694
09/17/1998	13.813	4068
09/16/1998	14.063	5789
09/15/1398	13.875	8813
09/14/1998	14.750	4486
09/11/1998	15.375	4910
09/10/1998	15.375	3138
09/09/1998	16.250	4108
09/08/1998	17.000	6924
09/04/1998	16.813	2451
09/03/1998	16.125	2886
09/02/1998	17.063	7205
09/01/1998	16.813	10110
08/31/1998	16.500	11425
08/28/1998	17.000	4696
08/27/1998	17.625	3086
08/26/1998	18.938	4508
08/25/1998	19.750	3862
08/24/1998	20.063	7312
08/21/1998	20.500	11635
08/20/1998	20.875	6731
08/19/1998	21.250	6215
08/18/1998	21.625	9689
08/17/1998	22.000	5981
08/14/1998	22.875	1638
08/13/1998	23.500	2690
08/12/1998	24.063	1826
08/11/1998	23.875	3577
08/10/1998	24.313	1957
08/07/1998	24.625	7858

Appendix D

Date	Close	Volume (00s)
08/06/1998	24.438	6553
08/05/1998	24.125	3678
08/04/1998	23.938	8136
08/03/1998	25.125	4792
07/31/1998	25.750	7122
07/30/1998	25.750	4511
07/29/1998	25.813	4638
07/28/1998	25.500	7271
07/27/1998	25.813	4603
07/24/1998	25.500	3560
07/23/1998	25.250	3473
07/22/1998	25.313	4815
07/21/1998	24.125	5318
07/20/1098	25.750	4759
07/17/1998	26.750	12947
07/16/1998	25.875	18563
07/15/1998	24.938	20670
07/14/1999	22.500	21383
07/13/1998	22.125	10597
07/10/1998	21.938	10023
07/09/1998	22.500	7479
07/08/1998	22.688	4925
07/07/1998	22.000	5165
07/06/1998	22.188	1906
07/02/1998	22.313	3016
07/01/1998	22.313	11734
06/30/1998	22.375	8241
06/29/1998	23.125	4675
06/26/1998	23.313	4928
06/25/1998	24.375	4635

Appendix D

Date	Close	Volume (00s)
06/24/1998	24.125	7893
06/23/1998	23.125	10393
06/22/1998	22.500	8613
06/19/1998	21.688	13190
06/18/1998	22.875	18429
06/17/1998	24.375	14619
06/16/1998	24.000	15927
06/15/1998	26.125	4972
06/12/1998	27.563	2324
06/11/1998	27.500	11000
06/10/1998	28.500	7187
06/09/1998	28.250	8555
06/08/1998	27.438	5732
06/05/1998	25.938	1905
06/04/1998	25.563	2028
06/03/1998	25.563	2753
06/02/1998	25.625	4502
06/01/1998	26.031	2823
05/29/1998	26.063	2891
05/28/1998	26.438	3030
05/27/1998	25.625	5811
05/26/1998	25.438	3680
05/22/1998	2.6.500	1873
05/21/1998	27.125	4092
05/20/1998	27.688	3663
05/19/1998	27.688	4857
05/18/1998	28.188	5739
05/15/1998	27.750	4800
05/14/1998	27.625	3673
05/13/1998	27.813	12245

Appendix D

Date	Close	Volume (00s)
05/12/1998	27.250	13504
05/11/1998	25.688	3776
05/08/1998	25.938	7717
05/07/1998	25.250	3512
05/06/1998	25.500	2976
05/05/1998	26.125	1992
05/04/1998	26.000	4815
05/01/1998	25.813	4031
04/30/1998	26.500	10550
04/29/1998	25.313	3964
04/28/1998	24.625	2793
04/27/1998	24.313	5623
04/24/1998	25.313	4997
04/23/1998	25.563	6973
04/22/1998	26.438	14634
04/21/1998	26.281	24282
04/20/1998	24.688	16643
04/17/1998	23.000	14145
04/16/1998	23.313	17203
04/15/1998	22.625	11706
04/14/1998	23.000	5999
04/13/1998	23.063	4652
04/09/1998	23.750	10633
04/08/1398	23.125	10824
04/07/1998	23.189	13605
04/06/1999	23.938	9041
04/03/1998	23.813	15305
04/02/1998	23.500	16796
04/01/1998	23.813	31467
03/31/1998	24.625	29131

Appendix D

Date	Close	Volume (00s)
03/30/1998	26.000	11186
03/27/1998	26.250	6513
03/26/1998	27.000	5110
03/25/1998	27.125	7237
03/24/1998	27.250	5592
03/23/1998	27.750	6536
03/20/1998	27.656	11937
03/19/1998	28.250	28970
03/18/1998	26.500	15866
03/17/1998	25.563	13837
03/16/1998	24.938	6886
03/13/1998	24.813	5270
03/12/1998	24.875	16869
03/11/1998	24.000	8717
03/10/1998	24.375	11177
03/09/1998	24.063	11718
03/06/1998	24.563	15456
03/05/1998	23.375	13913
03/04/1998	24.063	13886
03/03/1998	24.500	14225
03/02/1998	25.000	22564
02/27/1998	25.125	49143
02/26/1998	26.375	98641
02/25/1998	23.938	323919
02/24/1998	38.125	12318
02/23/1998	38.688	13824
02/20/1998	37.063	17388
02/19/1998	37.500	15345
02/18/1998	37.875	10388
02/17/1998	37.625	20501

Appendix D

Date	Close	Volume (00s)
02/13/1998	38.750	4844
02/12/1998	38.688	9504
02/11/1998	39.625	10751
02/10/1998	40.750	7667
02/09/1998	40.375	9354
02/06/1999	39.313	18044
02/05/1998	37.000	9636
02/04/1998	37.125	23946
02/03/1998	36.438	22278
02/02/1998	40.188	12502
01/30/1998	39.688	10343
01/29/1998	39.375	11261
01/28/1998	40.063	18954
01/27/1998	40.500	14239
01/26/1998	42.000	5461
01/23/1998	42.313	3149
01/22/1998.	43.000	7329
01/21/1998	44.125	16383
01/20/1998	42.750	25667
01/16/1998	46.250	7418
01/15/1998	45.000	4416
01/14/1998	46.125	8672
01/13/1998	45.125	7034
01/12/1998	43.250	8079
01/09/1998	43.563	4454
01/08/1998	45.063	1954
01/07/1998	46.000	3247
01/06/1998	46.750	6293
01/05/1998	47.500	5783
01/02/1998	46.125	2150

Appendix D

Date	Close	Volume (00s)
12/31/1997	45.875	3045
12/30/1997	46.125	14633
12/29/1997	43.750	5222
12/26/1997	43.750	763
12/24/1997	43.625	738
12/23/1997	44.000	1369
12/22/1997	44.625	2463
12/19/1997	44.875	4595
12/18/1997	45.688	6504
12/17/1997	43.625	5157
12/16/1997	43.875	2176
12/15/1997	44.750	3481
12/12/1997	45.625	2111
12/11/1997	46.000	3339
12/10/1997	46.250	4494
12/09/1997	46.938	5528
12/08/1997	48.000	7073
12/05/1997	46.750	3129
12/04/1997	46.375	4641
12/03/1997	44.188	6458
12/02/1997	44.500	3486
12/01/1997	44.250	3868
11/28/1997	43.875	1949
11/26/1997	44.000	2555
11/25/1997	43.813	4472
11/24/1997	43.813	3900
11/21/1997	46.625	2486
11/20/1997	46.375	4128
11/19/1997	45.750	2615
11/18/1997	45.625	1448

Appendix D

Date	Close	Volume (00s)
11/17/1997	45.625	2746
11/14/1997	44.250	5864
11/13/1997	45.875	5866
11/12/1997	45.875	4753
11/11/1997	47.125	2005
11/10/1997	48.375	3373
11/07/1997	47.375	1072
11/06/1997	48.250	1413
11/05/1997	48.750	2910
11/04/1997	48.500	3996
11/03/1997	48.813	3589
10/31/1997	48.375	2206
10/30/1997	47.375	5923
10/29/1997	46.500	5068
10/28/1997	45.250	8911
10/27/1997	43.250	4750
10/24/1997	48.500	3170
10/23/1997	49.000	6301
10/22/1997	49.375	5213
10/21/1997	48.000	7683
10/20/1997	49.000	6119
10/17/1997	49.063	11007
10/16/1997	50.563	3537
10/15/1997	49.938	5771
10/14/1997	51.688	10410
10/13/1997	52.875	6476
10/10/1997	51.500	5291
10/09/1997	49.625	10509
10/08/1997	51.000	14452
10/07/1997	47.375	3458

Appendix D

Date	Close	Volume (00s)
10/06/1997	46.625	5367
10/03/1997	47.000	6745
10/02/1997	45.125	3220
10/01/1997	45.000	5324
09/30/1997	43.625	3134
09/29/1997	44.125	4058
09/26/1997	43.125	5587
09/25/1997	43.000	7158
09/24/1997	44.750	6762
09/23/1997	44.250	8830
09/22/1997	44.000	5307
09/19/1997	43.625	5177
09/18/1997	43.750	4635
09/17/1997	43.250	8239
09/16/1997	41.500	4693
09/15/1997	40.375	2321
09/12/1997	40.500	2446
09/11/1997	40.000	2112
09/10/1997	39.750	4392
09/09/1997	40.375	4395
09/08/1997	40.250	3341
09/05/1997	40.375	8497
09/04/1997	39.188	10545
09/03/1997	37.875	8388
09/02/1997	37.625	13562
08/29/1997	35.625	7023
08/28/1997	35.188	6273
08/27/1997	35.438	9576
08/26/1997	35.250	5022
08/25/1997	35.875	3695

Appendix D

Date	Close	Volume (00s)
08/22/1997	36.000	7268
08/21/1997	36.500	5115
08/20/1997	36.500	11793
08/19/1997	35.500	18061
08/18/1997	33.375	6551
08/15/1997	33.625	5746
08/14/1997	34.625	6665
08/13/1997	34.250	7515
08/12/1997	34.500	677
08/11/1997	34.250	21599
08/08/1997	34.250	14942
08/07/1997	37.313	8080
08/06/1997	39.125	5390
08/05/1997	38.875	8558
08/04/1997	39.875	4607
08/01/1997	39.313	6619
07/31/1997	39.000	4780
07/30/1997	39.625	19510
07/29/1997	37.063	8114
07/28/1997	37.188	11398
07/25/1997	39.250	13954
07/24/1997	41.063	5959
07/23/1997	42.000	6052
07/22/1997	42.125	6585
07/21/1997	41.625	3222
07/18/1997	41.625	5395
07/17/1997	42.250	3016
07/16/1997	43.375	4560
07/15/1997	43.125	9249
07/14/1997	42.500	9644

Appendix D

Date	Close	Volume (00s)
07/11/1997	40.563	3399
07/10/1997	40.125	4194
07/09/1997	40.125	5165
07/08/1997	41.313	8726
07/07/1997	42.750	6616
07/03/1997	43.250	2060
07/02/1997	43.563	12153
07/01/1997	42.375	5402
06/30/1997	39.875	11100
06/27/1997	41.875	3680
06/26/1997	39.875	5874
06/25/1997	38.250	6291
06/24/1997	39.000	11462
06/23/1997	42.750	1956
06/20/1997	43.125	2823
06/19/1997	43.250	3346
06/18/1997	41.750	2080
06/17/1997	41.625	2998
06/16/1997	42.500	3695
06/13/1997	41.250	3668
06/12/1997	41.438	1746
06/11/1997	40.375	3897
06/10/1997	41.250	3155
06/09/1997	39.750	1898
06/06/1997	40.063	1672
06/05/1997	39.063	3061
06/04/1997	39.625	1735
06/03/1997	39.500	818
06/02/1997	40.063	1774
05/30/1997	39.750	2211

Appendix D

Date	Close	Volume (00s)
05/29/1997	40.250	7013
05/28/1997	39.938	2780
05/27/1997	42.563	2646
05/23/1997	42.875	4446
05/22/1997	41.250	6580
05/21/1997	40.750	3855
05/20/1997	40.625	5284
05/19/1997	39.500	3749
05/16/1997	38.750	1173
05/15/1997	39.125	2879
05/14/1997	39.250	8551
05/13/1997	37.625	3291
05/12/1997	37.000	3474
05/09/1997	36.250	4103
05/08/1997	36.125	4935
05/07/1997	37.000	20960
05/06/1997	34.500	4401
05/05/1997	35.125	4666
05/02/1997	33.875	5927
05/01/1997	30.125	5454
04/30/1997	29.000	15474
04/29/1997	27.625	4979
04/28/1997	27.250	9333
04/25/1997	25.000	10327
04/24/1997	29.500	14363
04/23/1997	32.000	4306
04/22/1997	32.063	4632
04/21/1997	34.125	4268
04/18/1997	34.625	851
04/17/1997	33.813	2042

Appendix D

Date	Close	Volume (00s)
04/16/1997	34.000	3395
04/15/1997	34.000	13341
04/14/1997	28.813	8368
04/11/1997	30.750	4312
04/10/1997	32.000	4461
04/09/1997	32.000	5321
04/08/1997	31.875	6408
04/07/1997	32.063	11876
04/04/1997	33.875	5089
04/03/1997	33.625	3444
04/02/1997	33.875	5134
04/01/1997	35.750	1278
03/31/1997	35.750	2181
03/27/1997	36.813	1528
03/26/1997	36.938	3352
03/25/1997	38.500	4688
03/24/1997	35.500	4081
03/21/1997	35.250	3250
03/20/1997	37.000	3742
03/19/1997	36.125	3318
03/18/1997	36.250	4949
03/17/1997	36.125	5560
03/14/1997	32.313	1532
03/13/1997	38.313	2890
03/12/1997	38.625	4413
03/11/1997	39.000	7356
03/10/1997	39.000	3876
03/07/1997	39.375	4831
03/06/1997	37.250	5609
03/05/1997	36.750	8412

Appendix D

Date	Close	Volume (00s)
03/04/1997	34.750	2633
03/03/1997	34.000	2706
02/28/1997	33.625	9230
02/27/1997	34.000	7478
02/26/1997	35.625	8131
02/25/1997	37.250	1359
02/24/1997	37.500	2089
02/21/1997	37.750	2521
02/20/1997	32.875	2591
02/19/1997	39.375	4301
02/18/1997	39.000	3266
02/14/1997	33.313	699
02/13/1997	39.875	4983
02/12/1997	39.125	5864
02/11/1997	37.500	5802
02/10/1997	39.875	5926
02/07/1997	40.375	1321
02/06/1997	40.125	2222
02/05/1997	40.125	1723
02/04/1997	41.000	1078
02/03/1997	41.750	1537
01/31/1997	42.000	2107
01/30/1997	41.750	2243
01/29/1997	43.000	1228
01/28/1997	42.250	4032
01/27/1997	40.250	1195
01/24/1997	42.000	1270
01/23/1997	42.750	2321
01/22/1997	41.750	3894
01/21/1997	42.500	9228

Appendix D

Date	Close	Volume (00s)
01/20/1997	41.938	2585
01/17/1997	43.250	1726
01/16/1997	43.500	5455
01/15/1997	44.625	4918
01/14/1997	43.125	3500
01/13/1997	39.750	1716
01/10/1997	40.063	2582
01/09/1997	40.625	3843
01/08/1997	40.250	3869
01/07/1997	41.500	4701
01/06/1997	42.000	2250
01/03/1997	43.750	2297
01/02/1997	43.500	7962
12/31/1996	47.750	8194
12/30/1996	45.125	1646
12/27/1990	44.625	3472
12/26/1996	46.000	3136
12/24/1996	43.750	3400
12/23/1996	40.563	2670
12/20/1996	42.875	6492
12/19/1996	43.500	8638
12/18/1996	42.000	9048
12/17/1996	37.000	8652
12/16/1996	36.000	5235
12/13/1996	39.125	4899
12/12/1996	39.625	4243
12/11/1996	40.500	8572
12/10/1996	41.750	8641
12/09/1996	37.750	3534
12/06/1996	37.625	7324

Appendix D

Date	Close	Volume (00s)
12/05/1996	39.250	5257
12/04/1996	38.250	5631
12/03/1996	37.875	4289
12/02/1996	38.500	3917
11/29/1996	37.000	1368
11/27/1996	38.250	8225
11/26/1996	35.000	12358
11/25/1996	34.250	4603
11/22/1996	32.875	3377
11/21/1996	32.000	3256
11/20/1996	32.000	4814
11/19/1996	32.125	2910
11/18/1996	31.625	6607
11/15/1996	33.625	3267
11/14/1996	33.250	4989
11/13/1996	33.625	22079
11/12/1996	33.500	1868
11/11/1996	33.000	976
11/08/1996	34.250	1067
11/07/1996	34.500	4213
11/06/1996	34.375	5394
11/05/1996	31.500	2634
11/04/1996	33.250	2017
11/01/1996	35.250	2014
10/31/1996	34.500	1405
10/30/1996	33.500	2550
10/29/1996	35.125	1006
10/28/1990	35.500	4398
10/25/1996	34.500	3120
10/24/1996	36.000	1255

Appendix D

Date	Close	Volume (00s)
10/23/1996	35.500	2836
10/22/1996	34.000	6022
10/21/1996	33.500	4653
10/18/1996	33.250	4331
10/17/1996	34.000	3303
10/16/1996	34.750	5542
10/15/1996	35.000	10711
10/14/1995	33.750	2279
10/11/1996	32.500	17428
10/10/1996	33.250	4069
10/09/1996	32.500	4389
10/08/1996	33.750	2478
10/07/1990	35.250	1473
10/04/1996	37.000	1216
10/03/1996	36.250	1638
10/02/1996	37.000	1607
10/01/1996	35.500	1716
09/30/1996	36.875	2777
09/27/1996	37.500	2067
09/26/1996	37.500	4565
09/25/1996	37.000	3006
09/24/1996	37.250	4617
09/23/1996	36.750	1446
09/20/1996	39.500	4602
09/19/1996	40.000	2718
09/18/1990	38.000	2742
09/17/1996	38.500	3222
09/16/1996	38.500	3321
09/13/1996	38.750	3279
09/12/1996	36.500	1887

Appendix D

Date	Close	Volume (00s)
09/11/1996	38.000	6984
09/10/1996	36.250	10925
09/09/1996	34.875	3286
09/06/1996	34.500	2943
09/05/1996	33.500	3396
09/04/1996	33.750	3963
09/03/1996	32.750	10225
08/30/1996	34.750	4124
08/29/1996	34.750	10302
08/28/1996	34.438	9883
08/27/1996	34.750	7736
08/26/1996	32.000	2474
08/23/1996	31.375	5503
08/22/1996	32.500	19863
08/21/1996	26.750	136
08/20/1996	26.500	134
08/19/1996	27.000	1368
08/16/1996	27.375	1074
08/15/1996	28.250	784
08/14/1990	28.000	1635
08/13/1996	27.000	1654
08/12/1996	26.500	1835
08/09/1996	28.125	1228
08/08/1996	27.750	2181
08/07/1996	28.000	4322
08/06/1996	26.500	1927
08/05/1996	26.500	6655
08/02/1996	24.250	7658
08/01/1996	23.750	4425
07/31/1996	23.250	3884

Appendix D

Date	Close	Volume (00s)
07/30/1996	21.375	1454
07/29/1996	21.500	4226
07/26/1996	22.750	6387
07/25/1996	24.375	6543
07/24/1996	21.750	7789
07/23/1996	21.500	3863
07/22/1996	24.688	3441
07/19/1996	25.250	4479
07/18/1996	25.750	7064
07/17/1996	24.375	8571
07/16/1996	22.000	15963
07/15/1996	25.000	3852
07/12/1996	27.000	6062
07/11/1996	25.500	5336
07/10/1996	27.250	1757
07/09/1996	26.938	4505
07/08/1990	27.500	5063
07/05/1996	27.250	4014
07/03/1996	28.250	3914
07/02/1996	26.500	6442
07/01/1996	29.625	21314
06/28/1996	28.000	18229
06/27/1990	24.188	22004
06/26/1996	23.688	12512
06/25/1996	25.750	15063
06/24/1996	26.625	4544
06/21/1996	26.625	4870
06/20/1996	27.242	8671
06/19/1996	26.875	18629
06/18/1996	27.688	40158

Appendix D

Date	Close	Volume (00s)
06/17/1996	32.313	4118
06/14/1996	32.250	7681
06/13/1996	34.500	10121
06/12/1996	33.375	9359
06/11/1996	33.250	6879
06/10/1996	34.000	6236
06/07/1996	34.063	11863
06/06/1996	33.688	9634
06/05/1996	33.063	9997
06/04/1996	31.875	7846
06/03/1996	31.375	10594
05/31/1996	30.813	5966
05/30/1996	30.688	8541
05/29/1996	29.625	6741
05/28/1996	30.563	8703
05/24/1996	31.250	15960
05/23/1996	29.438	33869
05/22/1996	29.688	2275
05/21/1996	29.750	2070
05/20/1996	29.938	4419
05/17/1996	29.875	1528
05/16/1996	29.875	4246
05/15/1996	29.000	3001
05/14/1996	29.688	4091
05/13/1996	28.438	1465
05/10/1996	29.250	3679
05/09/1996	28.439	7135
05/08/1996	27.063	8611
05/07/1996	27.156	1598
05/06/1996	28.000	6823

Appendix D

Date	Close	Volume (00s)
05/03/1996	28.875	12793
05/02/1996	25.813	5145
05/01/1996	27.375	7476
04/30/1996	26.750	4661
04/29/1996	27.625	5704
04/26/1996	29.000	2490
04/25/1996	29.469	6700
04/24/1996	29.813	12236
04/23/1996	26.750	4693
04/22/1996	26.375	5175
04/19/1996	25.125	2903
04/18/1996	26.000	1177
04/17/1996	26.250	4187
04/16/1996	25.750	8022
04/15/1996	24.750	2473
04/12/1996	24.188	1024
04/11/1996	24.250	4209
04/10/1996	24.438	7010
04/09/1996	24.000	1526
04/08/1996	24.000	3234
04/04/1996	24.125	2093
04/03/1996	24.750	3201
04/02/1996	24.500	818
04/01/1996	24.625	4151
03/29/1996	24.313	8527
03/28/1996	23.750	2929
03/27/1996	24.375	4693
03/26/1996	24.625	4580
03/25/1996	24.875	3920
03/22/1996	26.375	1287

Appendix D

Date	Close	Volume (00s)
03/21/1996	26.250	4884
03/20/1996	26.375	5751
03/19/1996	25.625	5171
03/18/1996	24.750	4014
03/15/1996	24.000	2818
03/14/1996	24.500	10028
03/13/1996	22.188	15099
03/12/1996	21.375	10143
03/11/1996	22.500	8055
03/08/1996	22.000	4006
03/07/1996	22.875	3047
03/06/1996	21.875	2826
03/05/1996	22.000	4204
03/04/1996	21.125	925
03/01/1996	20.750	1507
02/29/1996	21.1[illegible]	1849
02/28/1996	21.250	3267
02/27/1996	20.750	5293
02/26/1996	20.625	3858
02/23/1996	20.500	5702
02/22/1996	19.250	903
02/21/1996	19.375	1529
02/20/1996	19.375	1307
02/16/1996	19.625	1310
02/15/1996	19.500	2494
02/14/1996	19.750	6016
02/13/1996	19.125	6291
02/12/1996	19.750	6096
02/09/1996	19.500	3322
02/08/1996	19.188	10214

Appendix D

Date	Close	Volume (00s)
02/07/1996	18.813	1432
02/06/1996	18.875	3507
02/05/1996	18.875	5233
02/02/1996	18.188	2268
02/01/1996	18.250	3331
01/31/1996	19.250	6116
01/30/1996	19.250	11093
01/29/1996	20.063	12692
01/26/1996	19.250	2578
01/25/1996	19.375	4696
01/24/1996	19.500	2968
01/23/1990	19.375	4270
01/22/1996	19.500	1958
01/19/1996	19.500	7260
01/18/1996	19.438	6736
01/17/1996	17.875	3221
01/16/1996	17.500	3595
01/15/1996	17.500	4406
01/12/1996	18.500	13039
01/11/1996	17.250	1589
01/10/1996	16.750	2779
01/09/1996	16.750	1567
01/08/1996	16.938	210
01/05/1996	17.125	3301
01/04/1996	16.875	7970
01/03/1996	17.375	2113
01/02/1996	16.813	10195
12/29/1995	17.375	3836
12/28/1995	16.875	6707
12/27/1995	17.000	15377

Appendix D

Date	Close	Volume (00s)
12/26/1995	15.625	3702
12/22/1995	14.500	6093
12/21/1995	13.875	8308
12/20/1995	13.813	2524
12/19/1995	14.469	1288
12/18/1995	14.000	2218
12/15/1995	14.500	2173
12/14/1995	15.250	960
12/13/1995	15.250	4635
12/12/1995	15.938	5047
12/11/1995	14.688	3695
12/08/1995	14.500	2112
12/07/1995	14.625	484
12/06/1995	14.625	695
12/05/1995	14.313	2586
12/04/1995	14.000	2324
12/01/1995	14.625	406
11/30/1995	14.625	829
11/29/1995	14.688	755
11/28/1995	14.625	3449
11/27/1995	14.250	1912
11/24/1995	13.625	70
11/22/1995	13.875	3839
11/21/1995	13.375	1109
11/20/1995	13.625	2940
11/17/1995	13.625	2142
11/16/1995	14.250	1597
11/15/1995	13.938	1876
11/14/1995	14.500	2231
11/13/1995	15.188	2917

Appendix D

Date	Close	Volume (00s)
11/10/1995	15.000	4515
11/09/1995	14.938	1718
11/08/1995	15.000	2182
11/07/1995	14.813	1961
11/06/1995	15.313	1883
11/03/1995	15.188	5735
11/02/1995	15.125	3944
11/01/1995	15.000	3622
10/31/1995	14.625	1553
10/30/1995	14.563	1734
10/27/1995	14.500	1553
10/26/1995	14.500	2720
10/25/1995	14.000	2707
10/24/1995	14.063	4878
10/23/1995	14.000	2998
10/20/1995	14.000	4067
10/19/1995	14.875	2146
10/18/1995	15.125	6132
10/17/1995	14.938	2732
10/16/1995	14.750	4153
10/13/1995	14.625	1007
10/12/1995	14.500	875
10/11/1995	14.375	3030
10/10/1995	14.125	883
10/09/1995	14.125	996
10/06/1995	14.375	1474
10/05/1995	14.438	3926
10/04/1995	14.188	5633
10/03/1995	14.000	1674
10/02/1995	14.438	3573

Appendix D

Date	Close	Volume (00s)
09/29/1995	14.875	18986
09/28/1995	17.375	34709
09/27/1995	14.563	4434
09/26/1995	14.250	4495
09/25/1995	14.500	4386
09/22/1995	13.750	1652
09/21/1995	13.375	6198
09/20/1995	13.000	933
09/19/1995	13.000	1968
09/18/1995	13.000	687
09/15/1995	13.000	609
09/14/1995	13.375	1355
09/13/1995	13.438	2324
09/12/1995	13.438	5935
09/11/1995	12.875	5701
09/08/1995	12.500	2909
09/07/1995	12.125	4970
09/06/1995	11.875	1693
09/05/1995	11.875	1536
09/01/1995	12.000	1254
08/31/1995	12.250	415
08/30/1995	12.250	1338
08/29/1995	12.250	1456
08/28/1995	12.125	727
08/25/1995	12.125	3206
08/24/1995	11.875	2307
08/23/1995	12.000	1424
08/22/1995	12.000	3919
08/21/1995	12.000	4098
08/18/1995	12.125	2676

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Date	Close	Volume (00s)
08/17/1995	12.375	4066
08/16/1995	12.375	585
08/15/1995	12.375	5860
08/14/1995	12.500	4770
08/11/1995	12.500	6539
08/10/1995	12.750	24392
08/09/1995	13.500	789
08/08/1995	13.375	3195
08/07/1995	13.563	3932
08/04/1995	13.000	3040
08/03/1995	13.125	1754
08/02/1995	13.438	5088
08/01/1995	13.375	1136
07/31/1995	12.875	3426
07/28/1995	13.000	1201
07/27/1995	13.063	2078
07/26/1995	13.313	3059
07/25/1995	13.000	5333
07/24/1995	12.375	2685
07/21/1995	11.500	441
07/20/1995	11.500	2997
07/19/1995	10.875	3513
07/18/1995	11.313	7676
07/17/1995	11.938	7266
07/14/1995	11.500	9217
07/13/1995	10.625	6166
07/12/1995	10.000	1051
07/11/1995	10.000	1338
07/10/1995	9.875	3771
07/07/1995	10.250	1470

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Date	Close	Volume (00s)
07/06/1995	10.000	2182
07/05/1995	9.375	3238
07/03/1995	9.219	1762
06/30/1995	9.406	3734
06/29/1995	9.375	9818
06/28/1995	9.000	1531
06/27/1995	9.250	11324
06/26/1995	9.125	1340
06/23/1995	8.875	461
06/22/1995	8.750	1426
06/21/1995	8.625	2868
06/20/1995	8.563	3446
06/19/1995	8.125	3090
06/16/1995	8.500	1254
06/15/1995	8.375	12467
06/14/1995	7.000	1050
06/13/1995	7.125	2565
06/12/1995	7.000	1459
06/09/1995	6.750	3295
06/08/1995	7.250	1708
06/07/1995	7.000	517
05/06/1995	7.188	2689
06/05/1995	7.188	1295
06/02/1995	7.250	6244
06/01/1995	7.000	2491
05/31/1995	7.500	1139
05/30/1995	7.375	355
05/26/1995	7.375	676
05/25/1995	7.469	546
05/24/1995	7.875	1092

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Date	Close	Volume (00s)
05/23/1995	7.844	2829
05/22/1995	7.500	1174
05/19/1995	7.625	3442
05/18/1995	7.750	1676
05/17/1995	7.625	914
05/16/1995	7.875	807
05/15/1995	7.750	648
05/12/1995	8.000	3616
05/11/1995	7.688	5923
05/10/1995	8.125	3348
05/09/1995	8.063	14906
05/08/1995	7.625	7758
05/05/1995	7.750	2183
05/04/1995	7.625	10095
05/03/1995	7.688	2941
05/02/1995	7.875	2060
05/01/1995	7.750	2638
04/28/1995	7.656	6899
04/27/1995	8.000	11694
04/26/1995	7.438	1114
04/25/1995	7.500	3296
04/24/1995	7.625	1650
04/21/1995	7.750	389
04/20/1995	7.750	1153
04/19/1995	7.750	17199
04/18/1995	8.125	6436
04/17/1995	7.625	279
04/13/1995	7.375	124
04/12/1995	7.500	125
04/11/1995	7.375	1452

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Date	Close	Volume (00s)
04/10/1995	7.250	70
04/07/1995	7.500	1288
04/06/1995	7.375	1347
04/05/1995	7.625	353
04/04/1995	7.750	5515
04/03/1995	7.625	1090
03/31/1995	7.438	601
03/30/1995	7.250	1935
03/29/1995	7.250	376
03/28/1995	7.250	6123
03/27/1995	7.250	825
03/24/1995	7.250	9487
03/23/1995	7.125	7717
03/22/1995	6.813	4651
03/21/1995	6.500	269
03/20/1995	6.375	1235
03/17/1995	6.250	1024
03/16/1995	6.438	1229
03/15/1995	6.250	4094
03/14/1995	6.000	2286
03/13/1995	6.500	1177
03/10/1995	6.500	62
03/09/1995	6.500	443
03/08/1995	6.500	698
03/07/1995	6.375	234
03/06/1995	6.625	215
03/03/1995	6.688	193
03/02/1995	6.500	787
03/01/1995	6.625	1918
02/28/1995	7.000	93

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Date	Close	Volume (00s)
02/27/1995	6.625	660
02/24/1995	6.688	1261
02/23/1995	6.750	1598
02/22/1995	7.000	1069
02/21/1995	6.500	2675
02/17/1995	6.375	144
02/16/1995	6.625	1140
02/15/1995	6.563	3064
02/14/1995	6.250	5479
02/13/1995	5.750	3293
02/10/1995	6.250	1301
02/09/1995	6.125	195
02/08/1995	6.250	550
02/07/1995	6.250	72
02/06/1995	6.375	2692
02/03/1995	6.313	385
02/02/1995	6.281	2129
02/01/1995	6.313	4211
01/31/1995	6.250	2663
01/30/1995	6.188	399
01/27/1995	6.250	34
01/26/1995	6.063	87
01/25/1995	6.125	52
01/24/1995	6.000	279
01/23/1995	6.125	377
01/20/1995	6.250	335
01/19/1995	6.500	546
01/18/1995	6.750	498
01/17/1995	6.875	776
01/16/1995	6.750	101

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Date	Close	Volume (00s)
01/13/1995	6.875	135
01/12/1995	6.938	811
01/11/1995	6.875	1069
01/10/1995	7.125	1803
01/09/1995	6.875	121
01/06/1995	7.063	360
01/05/1995	7.000	333
01/04/1995	7.125	1156
01/03/1995	7.125	787
12/30/1994	7.250	1481
12/29/1994	6.938	1095
12/28/1994	6.500	1928
12/27/1994	6.250	1512
12/23/1994	6.000	104
12/22/1994	6.125	92
12/21/1994	6.000	640
12/20/1994	5.750	2252
12/19/1994	5.938	2324
12/16/1994	6.125	391
12/15/1994	6.000	2026
12/14/1994	6.000	1486
12/13/1994	6.125	64
12/12/1994	6.250	236
12/09/1994	6.375	1657
12/08/1994	6.500	1327
12/07/1994	6.500	4784
12/06/1994	6.250	358
12/05/1994	6.250	630
12/02/1994	6.313	368
12/01/1994	6.250	717

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Date	Close	Volume (00s)
11/30/1994	6.500	62
11/29/1994	6.250	292
11/28/1994	6.250	1190
11/25/1994	6.250	38
11/23/1994	6.250	3186
11/22/1994	6.375	2552
11/21/1994	6.375	7041

Data supplied by The Nasdaq Stock Market and University of Chicago, CRSP. Data may differ from data appearing in newspapers due to trades executed outside of normal market hours (9:30 am EST to 4:00 pm EST) or corrections reported after 4:00 pm EST. Close and Volume data adjusted for stock dividends/splits as of the *ex-dividend date*.

* Indicates the stock did not trade during normal market hours. Closing price is the average of the best Bid and Ask quotes at the end of the day; any volume figure is from trades executed outside of normal market hours.

** Indicates a SmallCap Market stock prior to 7/1/92. Prior to this date. The Nasdaq Stock Market did not report closing prices for the SmallCap Market closing price is the average of the best Bid and Ask quotes at the end of the day.

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EXHIBIT AA

51ST STORY of Level 2 printed in FULL format.

Copyright 1998 PR Newswire Association, Inc.
PR Newswire

February 24, 1998, Tuesday

SECTION: Financial News

DISTRIBUTION: TO MEDICAL AND BUSINESS EDITORS

LENGTH: 653 words

HEADLINE: Dura Pharmaceuticals Announces Accelerated Investment in Sales Force Expansion and Lower Than Expected Revenues and Earnings for 1998 Based on Recent Sales Results

DATELINE: SAN DIEGO, Feb. 24

BODY:

Dura Pharmaceuticals, Inc. (Nasdaq: DURA) today announced that based on recent sales results it will accelerate its planned investment in its sales force expansion and that it anticipates lower than expected revenues and earnings for 1998. The Company plans to begin expanding its sales force immediately from 270 representatives to over 450 by year-end in order to increase the market penetration Ceclor(R) CD (cefaclor extended release tablets), to prepare for the launch

of Albuterol Spiros(TM) and to support the growth of the Company's other promoted products. Based on an analysis of its current product mix, the Company estimates that the combined effect of the sales force expansion and revenue shortfall will reduce earnings by approximately $0.50 per share for 1998.

"The proactive expansion of our sales force at this time clearly serves the long-term interests of the Company and its shareholders," stated Cam L. Garner, Dura's Chairman, President and CEO. "Investing now in a significant sales and marketing effort to support the growth of Ceclor(R) CD and other promoted products, prior to our expected first Spiros(R) launch, improves the prospect of future revenue and earnings growth of the Company. In addition, the expansion is a key strategic initiative to support our planned launch of Albuterol Spiros(TM), pending FDA approval. This in turn is expected to position us to more effectively launch successor Spiros products currently in the development pipeline. Through our relationship with Spiros Development Corporation II, we believe that we may have access to as many as five new products within the next four years, all of which should be enhanced by the increased market penetration that an expanded sales force provides."

"On the acquisition front, we fully expect that our strengthened sales and marketing capability, coupled with our available cash balance of nearly $400 million, will better position the Company for product acquisitions and will likely accelerate the financial inroad of such acquisitions," noted Garner.

"This expansion initiative represents a transition in the Company's development. We are confident that Dura's sales and marketing organization and our Spiros(R) technology platform will be strengthened as a result of our current investment plan and we remain highly optimistic and committed to the successful execution of our strategy."

Dura Pharmaceuticals, Inc. is a San Diego based developer and marketer of prescription pharmaceutical products for the treatment of allergies, asthma, and related respiratory conditions. Dura has focused on the U.S. respiratory market because of its size and growth opportunities through two major strategies: (1) acquiring respiratory prescription pharmaceuticals and/or businesses developing or marketing such pharmaceuticals targeted at high-prescribing respiratory physicians, and (2) developing Spiros, a pulmonary drug delivery system.

Except for the historical and factual information contained herein, the matters discussed in this press release may contain forward-looking statements which involve risks and uncertainties, including market conditions, competitive products and pricing, seasonality, Dura's ability to add additional people to support activities, the timely development of the Spiros(TM) system, the timely receipt of FDA approval, if at all, Dura's limited manufacturing experience, dependency upon third parties and their successful development efforts and other risks detailed from time to time in the Company's filings with the SEC. Actual results may differ materially from those projected. Forward-looking statements represent the Company's judgment as of the date of this release. Dura disclaims,

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however, any intent or obligation to update any forward-looking statements.

SOURCE Dura Pharmaceuticals, Inc.

CONTACT: Cam Garner, Chairman, President and CEO of Dura Pharmaceuticals, Inc., 619-457-2553

LANGUAGE: ENGLISH

LOAD-DATE: February 25, 1998

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EXHIBIT AB

33RD STORY of Level 2 printed in FULL format.

Copyright 1998 PR Newswire Association, Inc.
PR Newswire

November 4, 1998, Wednesday

SECTION: Financial News

DISTRIBUTION: TO BUSINESS AND MEDICAL EDITORS

LENGTH: 85.6 words

HEADLINE: Dura Pharmaceuticals and Spiros Development Corporation II Announce Receipt of FDA 12-Month Review Letter on Albuterol Spiros; Agency Requires Additional Information

DATELINE: SAN DIEGO, Nov 4

BODY:

Dura Pharmaceuticals, Inc. (Dura) (Nasdaq: DURA) and Spiros Development Corporation II, Inc. (Spiros Corp. II) (Nasdaq: SDCOZ) today announced the receipt of a complete response letter from the U.S. Food and Drug Administration (FDA) indicating that the Albuterol Spiros(TM) new drug application (NDA) is not approvable until certain deficiencies are addressed.

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The FDA has requested additional clinical trials on the to-be-marketed Spiros(R) inhaler in order to ensure inhaler reliability and replicate the clinical outcomes of the initial trials. The Agency has also requested the resolution of a number of chemistry, manufacturing and control issues. The letter raised no issues on the clinical data with the inhaler filed in the NDA demonstrating therapeutic comparability of Albuterol Spiros(TM) with Ventolin(R) (albuterol) MDI using standard lung function measures; however, issues were raised regarding electromechanical reliability. During the clinical trials, Dura made subsequent improvements which it believes has addressed these issues. A meeting with the FDA has been scheduled later this month to develop a mutually agreed upon plan to resolve the outstanding issues.

"Based on our current understanding of the FDA's response, we do not expect the launch of Albuterol Spiros(TM) in 1999," stated David Kabakoff, Ph.D., President of Dura Technologies and Chairman; President and CEO of Spiros Corp. II. "After further dialogue with FDA, we will be able to better estimate the schedule for the completion of the Albuterol Spiros(TM) development program. Since the filing of the NDA for Beclomethasone Spiros(TM) and further development of additional Spiros(R) respiratory products are contingent upon resolution of certain issues relating to Albuterol Spiros(TM), we expect that timelines for these products may be modified following further dialogue with the FDA."

"We remain confident in the Spiros(R) inhalation technology," said Cam L. Garner, Dura's Chairman and CEO. "We continue to believe that the Spiros(R) respiratory

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products under development will be significant contributors to the Dura product portfolio. It is important to note that Albuterol Spiros(TM) was not expected to contribute to earnings in 1999, so our previously communicated earnings expectations for that period remain unchanged. We are committed to realizing the full potential of this technology within and outside the field of respiratory care through both internal development and partnering agreements."

The Spiros(R) inhaler is designed to address limitations of other inhalation delivery systems, such as metered dose inhalers (MDIs) and other dry powder inhalers. In 1997, the U.S. market for inhaled asthma medications totaled nearly $2 billion, with MDIs representing the most common method of delivery. Most MDIs contain CFC propellants, which deplete the ozone layer and are subject to worldwide regulations aimed at eliminating their use. MDIs also generally require press-and-breathe coordination that many patients are unable to properly perform. Albuterol Spiros(TM) is being developed to compete in the established $700 million U.S. market for inhaled albuterol, the most frequently prescribed asthma medication worldwide.

Dura Pharmaceuticals, Inc. is a San Diego based developer and marketer of prescription pharmaceutical products for the treatment of allergies, asthma, and related respiratory conditions. Dura has focused on the U.S. respiratory market because of its size and growth opportunities through two major strategies: (1) acquiring respiratory prescription pharmaceuticals and/or businesses developing or marketing such pharmaceuticals targeted at high-prescribing respiratory physicians, and (2) developing Spiros(R), a pulmonary drug delivery system.

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Spiros Development Corporation II, Inc. is a separate public company formed primarily to fund the continued development of Spiros(R), a proprietary pulmonary drug delivery system, and to conduct formulation work, clinical trials and commercialization for defined asthma drugs in the Spiros(R) Inhalation System.

Except for the historical and factual information contained herein, the matters discussed in this press release may contain forward-looking statements which involve risks and uncertainties, including market conditions, competitive products and pricing, seasonality, Dura's ability to add additional people to support activities, the timely development of the Spiros(R) system, the timely receipt of FDA approval, if at all, Dura's limited manufacturing experience, dependency upon third parties and their successful development efforts and other risks detailed from time to time in the Companies' filings with the SEC. Actual results may differ materially from those projected. Forward-looking statements represent the Companies' judgment as of the date of this release. Each of Dura and Spiros Development Corp. II disclaim, however, any intent or obligation to update any forward-looking statements. SOURCE Dura Pharmaceuticals, Inc.

CONTACT: David Kabakoff, Ph.D., President Dura Technologies, Dura Pharmaceuticals, Chairman, President and Chief Executive Officer, Spiros Development Corporation II, 619-457-2553

LANGUAGE: ENGLISH

LOAD-DATE: November 5, 1998

APPENDIX E — EXCERPT (PAGE 21) FROM MARCH 26, 2001 TRANSCRIPT OF PROCEEDINGS BEFORE THE HONORABLE M. JAMES LORENZ

UNITED STATES DISTRICT COURT SOUTHERN DISTRICT OF CALIFORNIA

CASE NO. 99CV01.51
SAN DIEGO, CA
MARCH 26, 2001
10:35 A.M.

BROUDO, ET AL,

PLAINTIFFS,

DURA PHARMACEUTICALS, ET AL,

DEFENDANTS.

TRANSCRIPT OF PROCEEDINGS
BEFORE THE HONORABLE. M. JAMES LORENZ
WITHOUT A JURY

APPEARANCES:

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Appendix E

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[21] STOCK AT THE END OF THE CLASS PERIOD CAN BE PROBATIVE OF INFLATION DURING THE CLASS PERIOD, BUT IT'S NOT A REQUIREMENT THAT THE REASONS FOR THE DECLINE ON THE DAY IT'S ANNOUNCED TIE DIRECTLY TO THE REASONS THAT IT WAS INFLATED. ALL THAT IS REQUIRED IS THAT THE PLAINTIFFS ESTABLISH THAT THE DEFENDANTS' CONDUCT CAUSED THEIR LOSS.

THE COURT: IS THERE SOME CASE LAW YOU CAN POINT ME TO ON THAT?

MR. ROSEN: YES. THE NINTH CIRCUIT DECISION IN *KNAPP V. ERNST WHITNEY* -- WOULD YOU LIKE THE CITE ON THAT, YOUR HONOR?

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THE COURT: YES.

MR. ROSEN: 90 FED 3RD [43]. AND THE JUMP CITE IS 1438. THAT IS A '96 DECISION.

THE COURT: THANK YOU.

MR: ROSEN: SURE. AS TO THE CORROBORATING DETAIL THAT PLAINTIFFS HAVE PROVIDED HERE -- WHERE I WAS GOING WITH THAT IS THAT THE DETAILS REGARDING MEMOS. THE DETAILS REGARDING MEETINGS, THE DETAILS REGARDING THE CLINICAL RESULTS THAT HAVE ALL BEEN ADDED INTO THIS SECOND AMENDED COMPLAINT, WHICH REFLECT THE RESULTS OF OUR INVESTIGATION, ARE MORE THAN ENOUGH TO PROVIDE THIS COURT WITH A SATISFACTION THAT THE ALLEGATIONS IN THIS CASE ARE NOT BOILERPLATE, AND THAT THE PLAINTIFFS HAVE PROVIDED CORROBORATING DETAIL.

AGAIN, REFERRING TO THE IN RE CELL PATHWAYS DECISION.

APPENDIX F — EXCERPT FROM (PAGES 18-21) (SECTION IV.A.) OF PLAINTIFFS-APPELLANTS' OPENING BRIEF TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 01-57136

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

In re DURA PHARMACEUTICALS, INC. SECURITIES LITIGATION

MICHAEL BROUDO, et al. On Behalf of Themselves and All Others Similarly Situated,

Plaintiffs-Appellants,

vs.

DURA PHARMACEUTICALS, INC., et al.,

Defendants-Appellees.

Appeal From the United States District Court
for the Southern District of California
No. 98-CV-00151-MJL(NLS)
The Honorable M. James Lorenz

PLAINTIFFS-APPELLANTS' OPENING BRIEF

Appendix F

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[TABLE OF CONTENTS AND TABLE OF AUTHORITIES INTENTIONALLY OMITTED]

* * * *

Appendix F

VI. ARGUMENT

A. The District Court Erred in Requiring a Corrective Stock Price Movement to Successfully Plead "Loss Causation"

The district court held that plaintiffs did not properly plead loss causation, despite allegations "that the stock price on the date of purchase was inflated because of the [defendants'] misrepresentations or omissions and that [plaintiffs] would not have purchased the stock had they known about Defendants' wrongdoing." ER95:15. "These allegations are not sufficient to withstand a motion to dismiss," concluded the court, because plaintiffs had not shown a connection between defendants' Albuterol Spiros misrepresentations and a subsequent corrective stock-price decline at the Class Period's close. ER95:15.

The district court was wrong. Its holding contradicts Ninth Circuit precedent, which holds that plaintiffs "establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." *Knapp*, 90 F.3d at 1438; *accord Gray v. First Winthrop Corp.*, 82 F.3d 877, 886 (9th Cir. 1996). Plaintiffs here did so by pleading that defendants' misrepresentations and omissions inflated the price of the Dura stock that they purchased in reliance upon the integrity of the market, and were injured thereby. *See* ER72:¶¶37, 179.

Under this Circuit's law, the "loss" to plaintiffs for §10(b) purposes is paying more than the stock's "true value" at the moment of purchase – not if and when some "corrective

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statements" drive the price back down. *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 (9th Cir. 1987); *see also Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1344 (9th Cir. 1976) (Sneed, J., concurring). The correct focus is on the stock's inflation at the moment of purchase – not on its price at some later time. *Wool*, 818 F.2d at 1437.

In a fraud-on-the-market case like this, loss causation and transaction causation are both inferred from the materiality of a misrepresentation or omission: "Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price – when the purchase is made the causational chain between defendants' conduct and plaintiff's loss is sufficiently established to make out a *prima facie* case." *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975); *accord Basic Inc. v. Levinson*, 485 U.S. 224, 242-45 (1988). The action "is not predicated solely on a showing of economic damage (loss causation)," realized when the stock is purchased. *Blackie*, 524 F.3d at 906.

When plaintiffs point to a stock drop as the amount of the inflation, they may show loss causation by alleging that defendants' false and misleading statements led to a stock-price fall upon disclosure. *See, e.g., Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir. 1996). They will have shown that the false and misleading statements """touch [] upon""" the reason's for the stock's decline in value. *Id.* (citation omitted). But a subsequent decline in price is not always required.

In *Blackie*, this Court rejected defendants' contention – similar to the district court's holding here – that the plaintiffs'

loss suffered at the time of purchase must be connected to a subsequent decline in the security's price:

> [Defendants] contend that the inflation paid must be measured by the change in price after a corrective release. That drop is of course circumstantial evidence of the inflation when purchased, but it is not the exclusive method of measuring inflation. The fact finder may rely on other methods of determining actual value on the date of purchase, including expert testimony on actual value .... In any event, the drop after a corrective disclosure will not be conclusive of the amount of original inflation.

524 F.2d at 909 n.25; *accord Wool*, 818 F.2d at 1437 & n.3; *Green*, 541 F.2d at 1346.

Similarly, in *Knapp*, this Court rejected defendants' "focus on the post-disclosure price ... as the true value of the stock." 90 F.3d at 1438. "Although the post-disclosure price may in some cases be evidence of the value of the stock before disclosure, the post-disclosure price is not a measure of pre-disclosure value." *Id.* Indeed, those investors who sell their inflated stock before corrective statements are made nonetheless "can suffer losses caused by the misrepresentation." *Id.* This Court flatly rejected defendants' arguments that "plaintiffs who both purchased and sold their stock before corrective statements had been made could not have established loss causation." *Id.* Corrective disclosures are not critical. *Id.*

Knapp cannot be reconciled with the district court's requirement that the Dura defendants make a corrective announcement concerning Albuterol Spiros at some time during the Class Period. Indeed, if the district court were correct, defendants could successfully insulate themselves from securities-fraud liability simply by refusing to ever "come clean" about their earlier falsehoods. This Court remarked upon this unsavory result in *Worlds of Wonder*, while reversing summary judgment in defendants' favor on §11 claims, because the district court ascribed to the "faulty premise" that defendants' falsehoods needed to be disclosed before liability could attach. *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1422 (9th Cir. 1994). If the premise were true, explained the Court, securities defendants could immunize themselves for fraudulent statements simply by refusing to correct the statements. *Id.*

The district court's view finds support in *Robbins v. Koger Props.*, 116 F.3d 1441 (11th Cir. 1997), where the Eleventh Circuit expressly rejects *Knapp*'s holding that plaintiffs establish loss causation "'if they have shown that the price on the date of purchase was inflated because of the misrepresentation.'" *Id.* at 1448 (quoting *Knapp*, 90 F.3d at 1438). Instead, says *Robbins*, the Eleventh Circuit's decisions "explicitly require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value." *Id.* But in this Circuit, *Robbins* does not control – *Knapp* does.

The district court thought *Binder v. Gillespie*, 184 F.3d 1059 (9th Cir. 1999) and *McGonigle v. Combs*, 968 F.2d 810 (9th Cir. 1992), required that defendants' misstatements must

be linked up with a subsequent stock-price decline upon disclosure, ER95:14-15, but neither case is so rigid. *Binder* correctly recognizes that the "touches upon" requirement is "amorphous," and decides against plaintiff because there "was no showing of any material misrepresentation or omissions . . . that can be said to have caused any investor loss." 184 F.3d at 1066. That analysis is consistent with *Knapp*'s focus on alleged inflation on the dates of purchase due to defendants' misstatements. *McGonigle* does not support the district court's holding, either, for the plaintiffs there simply failed to present evidence suggesting that defendants' omissions affected the security's value. 968 F.2d at 820-21. It never required any additional "decline in price."

Finally, if plaintiffs were required to plead a stock drop upon a corrective disclosure, the district court should have permitted them to do so in an amended complaint. Defendants' own stock chart, submitted as part of their Request for Judicial Notice, shows a dramatic 20% stock-price drop immediately following Dura's November 3, 1998, announcement that the FDA rejected Albuterol Spiros. *See* ER79:Ex. L. If this Court decides that leave to amend is warranted, plaintiffs could add this allegation to their Complaint.

Because plaintiffs alleged that defendants' material misstatements concerning Albuterol Spiros inflated the price of Dura stock that they purchased, ER72:¶¶37, 179, they have successfully pleaded loss causation. The following section explains how those statements were false and made with scienter.

15

No. 03-932

SEP 13 2004

IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR PETITIONERS

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QUESTION PRESENTED

Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price.

LIST OF PARTIES AND CORPORATE DISCLOSURE STATEMENT

The parties to the proceedings below are listed in the caption. In the caption page to its opinion, 339 F.3d 933 (9th Cir. 2003) (Pet. App. 1a-17a), the Ninth Circuit inadvertently listed certain non-parties as defendants/appellees. Merrill Lynch and Co./Merrill Lynch, Pierce, Fenner and Smith, Inc. and James C. Blair were omitted by the plaintiffs/respondents from the Consolidated Amended Complaint and did not appear before the court of appeals. Nissan Motor Co., a Japanese corporation, was never a party in this case.

Pursuant to Supreme Court Rule 29.6, petitioner Dura Pharmaceuticals, Inc. states that on December 31, 2001 Dura Pharmaceuticals, Inc. merged with and into Elan Pharmaceuticals, Inc., a privately held Delaware corporation, which is a wholly-owned subsidiary of Elan Corporation, plc. a publicly-traded entity.

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The opinion of the United States Court of Appeals for the Ninth Circuit filed August 5, 2003, is reported at 339 F.3d 933 (9th Cir. 2003) and reprinted at Pet. App. 1a-17a. The unreported order denying the petition for panel rehearing and rehearing *en banc* is reprinted at Pet. App. 52a-53a. The order of the district court granting petitioners' motion to dismiss the consolidated and amended complaint without prejudice is reported at 2000 WL 33176043 and Fed. Sec. L. Rep. (CCH) P 91, 245. The subsequent order of the district court granting petitioners' motion to dismiss the second amended complaint with prejudice is not reported, but is reprinted in the Appendix ("Pet. App.") at 18a-51a.

STATEMENT OF JURISDICTION

The court of appeals entered its opinion and order on August 5, 2003. A timely petition for rehearing and rehearing *en banc* was filed. On September 29, 2003, the panel denied the petition for rehearing and the suggestion for rehearing *en banc* was rejected.

The petition for writ of certiorari was filed on December 24, 2003, and was granted on June 28, 2004. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78a, *et seq.*, including the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), P.L. 104-67, 1995 HR 1058, involved are:

15 U.S.C. § 78u-4

(b) Requirements for securities fraud actions

* * *

(4) Loss Causation

In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

* * *

(e) Limitation on damages

(1) In general

Except as provided in paragraph (2), in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff

for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception

In any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.

* * *

These provisions are also reproduced at Pet. App. 54a-55a. In addition, the following provision under Section 12 of the Securities Act of 1933 is pertinent to the Court's consideration of this case:

15 U.S.C. § 77*l*

(b) Loss causation

In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

STATEMENT OF THE CASE

The question presented in this case concerns the proper standard for pleading the now Congressionally mandated element of "loss causation" in a private securities fraud claim brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. *See* 15 U.S.C. § 78u-4(b)(4). Specifically, this case concerns whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and a subsequent and corresponding decline in the value of the plaintiff's investment. In other words, where a plaintiff invokes the fraud-on-the-market theory to recover damages for a post-transaction decline in share price, must the plaintiff

allege that the defendant's alleged fraud actually caused that decline? In overturning the district court's dismissal of the plaintiffs' complaint on this basis, the Ninth Circuit has required no such causal link. According to the Ninth Circuit, in a fraud-on-the-market case, a plaintiff establishes loss causation on a bare allegation that a share's price on the date of purchase was "inflated" as a result of the alleged fraud – no showing of a subsequent decline in price associated with removing the alleged "inflation" is necessary.

A. Factual Background

Petitioner Dura Pharmaceuticals, Inc. ("Dura") was a San Diego-based developer and marketer of prescription pharmaceutical products for the treatment of allergies, asthma, and related respiratory conditions. The individual petitioners herein held various management and/or director positions with Dura. Respondents are investors who purchased shares of Dura between April 15, 1997 and February 24, 1998 (the "Class Period").

On February 24, 1998, Dura announced that it expected a revenue shortfall for the upcoming full year due to anticipated slow pharmaceutical sales, increased competition and a need to increase Dura's sales force. Joint Appendix ("JA") 142a-147a, 191a-194a; 51a: ¶ 32. The announcement said nothing about Albuterol Spiros, Dura's delivery device for asthma medication, which was in development in coordination with the United States Food and Drug Administration ("FDA"), but not yet FDA-approved. *Id.* Following this announcement, Dura's stock dropped from

$39.125 on February 24, 1998 to $20.75 on February 25, 1998, a 47% one-day loss. JA 51a: ¶ 32 [1]

On November 3, 1998, nearly nine months after Dura's February 24, 1998 announcement and the concurrent loss in stock price, Dura announced that the FDA did not approve Albuterol Spiros due to issues of electro-mechanical reliability and the need for additional clinical trials. JA 110a-111a: ¶ 136. Dura's share price declined somewhat following the November 3 announcement, from $12.375 to $9.75. JA 142a-147a, 156a. Within twelve trading days, however, the stock price recovered to $12.438, and within ninety days it closed at $14.00 per share. *Id.*

B. Respondents' Multiple Pleading Attempts

Respondents filed their initial complaint on January 27, 1999, nearly a year after the end of the alleged Class Period. Supplemental Excerpts of Record from the Ninth Circuit ("SER") 1. After the district court appointed lead plaintiffs and approved their choice of co-lead counsel, respondents filed a Consolidated Amended Complaint ("CAC") on October 7, 1999. SER 37. Respondents alleged that petitioners made materially false statements during the Class Period regarding, inter alia, the prospects of Albuterol Spiros. *Id.*: ¶¶ 20-23, 31. Respondents did not seek to recover losses associated with the November 3, 1998 announcement concerning Albuterol Spiros. SER 37. Indeed, nowhere in the CAC did respondents even mention the November 3, 1998 price decline. *Id.* Rather, respondents sought to recover for

1. Plaintiffs rely upon intra-day trading highs and lows in Dura common stock to enhance their allegations. On February 24, 1998 Dura's shares closed at $38.125. *See* JA 142a-147a, 162a. On February 25, 1998 Dura's shares closed at $23.938. *Id.*

the 47% decline in price that followed the February 24 announcement of an anticipated prospective revenue shortfall. *Id.*: ¶¶ 30, 36, 61, 93. On July 12, 2000, the district court granted petitioners' motion to dismiss the CAC without prejudice. SER 68. The district court admonished respondents that failure to comply with the requisite pleading standards may subject their complaint to dismissal with prejudice. SER 68, p. 26.

Respondents filed a Second Amended Complaint ("SAC") on September 25, 2000. JA 34a-141a. Similar to the CAC, respondents alleged, inter alia, that during the Class Period petitioners misled investors regarding the likelihood of FDA approval of Albuterol Spiros by failing to disclose that the products suffered from "electro-mechanical" defects and that Dura had made changes to the products during clinical testing, which would prevent the approval of its New Drug Application ("NDA") filed with FDA. *Id.*: ¶¶ 22-23, 33, 66-70. Similar to the allegations contained in the CAC, respondents did not mention the November 3, 1998 price decline associated with the announcement concerning Albuterol Spiros. JA 110a-111a. Respondents only sought to recover losses for the 47% price decline following the earlier February 24 announcement, which respondents do not allege made any mention of Albuterol Spiros. JA 34a-141a: ¶¶ 32, 39, 134, 172.

C. The District Court's Dismissal of the SAC

On November 2, 2001, the district court granted petitioners' motion to dismiss the Second Amended Complaint with prejudice and entered judgment in petitioners' favor. Pet. App. 51a. The district court found, in relevant part, that respondents' allegations concerning

Albuterol Spiros were insufficient to state a claim because plaintiffs failed to plead the requisite "loss causation."[2] Specifically, the district court focused on the end of the Class Period and Dura's announcement on February 24, 1998 which was followed by a stock price decline:

> The SAC does not allege that the February 24, 1998, announcement contained any negative information about Albuterol Spiros. Rather, Dura did not announce that the FDA would not approve Albuterol Spiros until nine months later, in November 1998. (SAC ¶ 136.) The SAC does not contain any allegations that the FDA's non-approval had any relationship to the February price drop. Accordingly, the SAC does not explain how the alleged misrepresentations and omissions regarding Albuterol Spiros "touched" upon the reasons for the decline in Dura's stock price. Rather, the decline in Dura's stock price was the result of an expected revenue shortfall.

Pet. App. 40a. The district court noted that because the February 24 announcement did not mention the Albuterol Spiros device, no omissions or misrepresentations about the device caused the decline in price. The district court expressly rejected respondents' contention that they had properly pleaded loss causation because they alleged that the stock price on the date of purchase was inflated because of the misrepresentations or omissions and they would not have purchased the stock had they known about the petitioners' wrongdoing. Pet. App. 40a.

2. In granting petitioners' motion to dismiss with prejudice, the district court also found that respondents failed to allege particularized facts establishing that any material statements were false or misleading when made, and failed to allege particularized facts establishing a strong inference of scienter. Pet. App. 18a-51a.

D. The Ninth Circuit's Decision

On respondents' appeal, the Ninth Circuit reversed the district court's dismissal of the SAC. Pet. App. 17a. The court of appeals acknowledged, consistent with the district court's reasoning, that the loss causation element is satisfied in the Ninth Circuit if "the plaintiff shows that 'the misrepresentation touches upon the reasons for the investment's decline.'" Pet. App. 8a. However, the Ninth Circuit found the "touches upon" language ambiguous. *Id.*

According to the Ninth Circuit, in a fraud-on-the-market case, plaintiffs establish loss causation if they plead that the stock price on the date of purchase was inflated because of the misrepresentation. Pet. App. 9a. The court of appeals concluded that the "injury" occurs at the time of the transaction and therefore, it is not necessary that a market price drop actually occur in order to establish loss causation. *Id.* According to the court of appeals, in order to establish loss causation, a plaintiff is not required to plead a stock price drop following a corrective disclosure. *Id.* Rather, to withstand a motion to dismiss, a plaintiff need only allege (1) that the price at the time of purchase was overvalued and (2) sufficient identification of the cause for the overvaluation. Pet. App. 10a.[3]

3. In addition to its holding regarding loss causation, the court of appeals also vacated and remanded the district court's finding of no allegations establishing a strong inference of scienter, instructing the district court to consider the plaintiffs' allegations of scienter in their totality, rather than separately. The court of appeals further found that the district court abused its discretion in denying leave to amend the SAC. Pet. App. 14a-16a. Because the court of appeals held that respondents had sufficiently pleaded loss causation by alleging artificial inflation at the time of purchase, respondents' potential amendments to the SAC will not affect the loss causation issue.

The court acknowledged that in contrast to its interpretation of loss causation, the Third and Eleventh Circuits apply a different standard. Those circuits, the court explained "do require demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint." Pet. App. 9a n.4 (*citing Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000), *cert. denied*, 531 U.S. 1149 (2001), and *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997)).

Petitioners sought from this Court a writ of certiorari to review the judgment of the Ninth Circuit. On March 8, 2004, the Court invited the Solicitor General to file a brief in this case expressing the views of the United States. *Dura Pharmaceuticals, Inc. v. Broudo*, 124 S. Ct. 1625 (2004). In its brief filed on May 28, 2004 in support of granting certiorari, the Solicitor General and the Securities Exchange Commission strongly opposed the Ninth Circuit's interpretation of loss causation, describing the Ninth Circuit's holding as "incorrect" and "erroneous." (SG Cert. Brief at 1, 6, 9, 10, 11). The Solicitor General clearly indicated that in order to establish loss causation, there must be an actual reductive effect in the price of the stock that results from disclosure of the alleged misrepresentation. As the Solicitor General reasoned:

> it cannot be said that an investor in a fraud-on-the-market case who purchases a security at an inflated price has suffered *any* loss at the time of purchase, much less one caused by the defendant's misrepresentation. . . . Measuring the loss in such a case as of the time of purchase, and not requiring any allegation of a *subsequent* loss of value

> attributable to the fraud, would grant a windfall to investors. . . .

(SG Cert. Brief at 11) (emphasis added).

On June 28, 2004, this Court granted certiorari.

SUMMARY OF ARGUMENT

There can be no question that in order for the loss causation requirement to have any meaningful application at the pleading stage, a plaintiff invoking the fraud-on-the-market theory must establish a causal connection between the defendant's alleged fraud and the post-transaction decline in stock price for which the plaintiff seeks to recover losses. The Reform Act, which codified the long recognized loss causation requirement in private securities fraud actions, specifically requires that a plaintiff plead and prove "that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). Contrary to the plain language of the Reform Act and well-established precedents regarding loss causation, the Ninth Circuit requires only that a plaintiff plead that the price of stock was artificially inflated at the time of purchase. As the Ninth Circuit held "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred. . . ." The Ninth Circuit's decision here has taken the "loss" out of "loss causation," thereby turning the required element on its head.

When viewed in light of the overall statutory scheme, the Ninth Circuit's interpretation of loss causation cannot be reconciled with the provisions of the Reform Act.

Particularly, the price inflation theory of loss causation is inconsistent with the Reform Act's limitation of damages provision, which defines a plaintiff's damages in terms of a post-transaction decline in value following a corrective disclosure. It is similarly inconsistent with the definition of loss causation contained elsewhere in the Reform Act, which defines loss causation as the link between a defendant's misconduct and a depreciation in the value of stock.

Since at least as early as 1974, loss causation has been recognized as a required element of private securities fraud claims brought under Section 10(b). *See Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974). Loss causation, which requires a plaintiff to show that the alleged misrepresentation caused the plaintiff's loss, is independent from the separate element of transaction causation, which requires a plaintiff to demonstrate that he relied upon a defendant's alleged misrepresentation when making his investment decision.[4] Loss causation requires a causal relationship between a defendant's conduct and a plaintiff's injury, allowing courts to consider factors unrelated to a defendant's alleged misconduct before imposing liability. Lest Section 10(b) become an insurance plan for unrelated losses whenever there is any misrepresentation made in connection with the purchase of a security, it simply is not enough for the plaintiff to allege only that the price of the stock was artificially inflated at the time of purchase.

4. Transaction causation and loss causation were acknowledged as separate and distinct elements in 10b-5 claims at least as early as 1974 in *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974). Transaction causation, discussed *infra* at II. B.1, is typically synonymous with reliance, and only explains why the plaintiff entered into the transaction. It does not explain what ultimately caused plaintiff's loss.

The Ninth Circuit's interpretation of loss causation improperly collapses the separate elements of transaction causation and loss causation. Where a plaintiff invokes the fraud-on-the-market theory to pursue its claims under Section 10(b), such as the case is here, the plaintiff is entitled to a rebuttable presumption of reliance – i.e., transaction causation. In other words, the plaintiff is entitled to a presumption that he relied on the integrity of the market price as reflecting all material information about a company. Requiring a plaintiff to allege only that the price of stock was artificially inflated at the time of purchase effectively eliminates any substantive loss causation element. *See Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003) (a plaintiff's allegation of only purchase-time value disparity is nothing more than a paraphrased allegation of transaction causation). As noted above and discussed *infra* at II. B., transaction causation and loss causation are independent and distinct elements, both of which must be established in order to sufficiently plead a securities fraud claim under Section 10(b).

Finally, the Ninth Circuit's decision here is fundamentally at odds with the efficient market theory, upon which all fraud-on-the-market securities class actions are based. That theory holds that in well-developed capital markets, all publicly available material information about a company is quickly reflected in the price of the company's stock. Accordingly, where a security's price is artificially inflated as a result of a material misrepresentation, the inflation will necessarily carry over until the truth is disclosed and absorbed by the market, resulting in a subsequent decline in the stock's price. It is only at this point that the investor plaintiff has suffered any "loss." Allowing a plaintiff to satisfy

loss causation on an allegation of price inflation alone has the potential to create a windfall for investors who sell prior to a corrective disclosure.[5]

In sum, the Ninth Circuit's price inflation theory of loss causation runs directly counter to basic principles of statutory interpretation, the jurisprudence of loss causation, and related sound policy reasons. In order for the Congressionally mandated element of "loss causation" to have any meaningful application in securities fraud cases, particularly at the pleading stage, a plaintiff must allege some direct tie between the fraudulent conduct alleged and the decline in stock price for which they seek to recover.

ARGUMENT

I. The Ninth Circuit's Approach Is Inconsistent With The Reform Act

One of the key issues facing Congress in 1995 was substantial concern over abusive and frivolous securities lawsuits filed by "professional" plaintiffs. H.R. Conf. Rep. 104-369 at 31-33 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-731. Congress recognized that these suits were frequently filed in the hopes of obtaining quick settlements by anxious defendants who were averse to litigation. *Id.* Congress further observed that these suits and the potential resultant settlements would increase the cost of raising capital and would chill corporate disclosure. *Id.* In response to these

5. *See* SG Cert. Brief at 11 ("Measuring the loss in [a fraud-on-the-market case] as of the time of purchase, and not requiring any allegation of a subsequent loss of value attributable to the fraud, would grant a windfall to investors who sold before the reduction or elimination of the artificial inflation.").

and other concerns, Congress enacted the Private Securities Litigation Reform Act of 1995. PL 104-67, 1995 HR 1058. In passing the Reform Act, Congress sought, in part, to establish uniform and stringent pleading requirements for securities fraud actions arising under Section 10(b) of the Securities Exchange Act of 1934. In this regard, Congress codified a plaintiff's burden of pleading and proving "loss causation" in 10(b) cases. Specifically, section 21D(b)(4) of the Reform Act, entitled "Loss causation", provides that "[i]n any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). When viewed in the context of the Reform Act's broad statutory scheme, it is clear that the Ninth Circuit's price inflation theory of loss causation is not sufficient to satisfy this Congressionally mandated requirement.

A. The Ninth Circuit's Interpretation Of Loss Causation Cannot Be Reconciled With The Reform Act's "Look Back" Damages Provision

The inconsistency between the Ninth Circuit's interpretation of loss causation and the Reform Act is particularly striking when construed with the Act's limitation on damages. In addition to codifying loss causation in the Reform Act, Congress also implemented therein an upward damages limitation in order to confine a plaintiff's recovery to those losses actually caused by the fraud and not by other market conditions for which defendants should not be held responsible. Specifically, section 21D(e)(1) of the Reform Act provides:

> Except as provided in paragraph (2), in any private action arising under this chapter in which the

> plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which *the information correcting the misstatement or omission that is the basis for the action is disseminated to the market*.

15 U.S.C § 78u-4(e)(1) (emphasis added) (reproduced at Pet. App. 54a-55a). This provision of the Reform Act has been referred to as the "look back" provision. In defining a plaintiff's damages in a Section 10(b) securities case, this provision not only imposes limitations upon the plaintiff's recovery based upon the amount of the post-transaction decline in value, but it also makes no sense unless loss causation requires that a corrective disclosure of the alleged misrepresentation or omission caused such a decline. .

The Ninth Circuit's interpretation of loss causation, which is based solely on a theory of price inflation at the time of purchase, would render the Reform Act's "look back" provision inoperative. If, as the Ninth Circuit has held, a plaintiff can establish loss causation merely by alleging that the stock was artificially inflated as the result of defendant's fraud, it presumably does not matter whether the share price actually experiences a related decline. Consequently, the 90-day "look back" period, which is intended to limit plaintiffs' potentially available damages where a stock does not decline, or declines but then recovers, is rendered moot. Similarly, the respondents here should not be entitled to any damages, even though in the Ninth Circuit's view they adequately

pleaded loss causation. Pursuant to the "look back" provision, the day the corrective disclosure is made to the public is relevant to the determination of damages. Here, the loss for which respondents sought to recover is the stock price decline that occurred on February 24, 1998. However, the "corrective disclosure" relating to Albuterol Spiros was not made until nine months later – after the close of the Class Period. Congress could not possibly have intended such an absurd inconsistency between the loss causation requirement and the "look back" provision governing the availability of damages.

Consistency with the "look back" provision requires that a plaintiff prove a causal connection between the defendant's alleged fraud and the post-transaction decline in value. Indeed, such a causal connection is necessary in order for the damages provision to have any practical effect. If a defendant's fraud did not cause the post-transaction decline, it would make no sense for that decline and any subsequent recovery to govern the damages available to the plaintiff. Moreover, as noted by the Banking, Housing and Urban Affairs Committee of the United States Senate, by including the limitation on damages provision in the Reform Act, the Committee intended to rectify the uncertainty in calculating damages in securities fraud cases, "thereby limiting damages to those losses caused by the fraud and not other market conditions." S. Rep. No. 104-98 at 20 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 699.

B. The Ninth Circuit's Understanding Of Loss Causation Cannot Be Reconciled With The Definition Of That Term In Section 105 Of The Reform Act

In addition to codifying the required element of loss causation for securities fraud actions arising under Section 10(b) of the Securities Exchange Act of 1934, the Reform Act also codified the element of loss causation as applied to private actions brought under Section 12 of the Securities Act of 1933, which expressly creates a private cause of action for material misstatements and omissions made in connection with an offer or sale of a security. PL 104-67 § 105, 1995 HR 1058; 15 U.S.C. § 77*l*(b). Notably, Section 105 of the Reform Act amended Section 12 to provide defendants in such cases with an affirmative defense of loss causation. *Id.* Although the application of "loss causation" under the two sections is different in that under Section 10(b) it is a required element of plaintiff's case, and under Section 12 it is an affirmative defense, Section 105 shows what Congress intended by the term "loss causation," thereby placing the loss causation requirement under Section 10(b) in context.

Section 105 specifically provides:

> (b) Loss causation
>
> In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

Id.

Section 105 thus clearly defines "loss causation" in terms of the link between defendant's false statements and the "depreciation in value of the subject security. . . ." Such "depreciation in value" definition of loss causation cannot be reconciled with a standard that is satisfied entirely if there is artificial inflation at the time of purchase. As illustrated by Section 105, Congress clearly intended that inflation without a decline is not a "loss" for purposes of loss causation.

When interpreting a statutory provision, this Court will consider its place in the broad statutory scheme, rather than analyzing statutory language in isolation. *Reno v. Koray*, 515 U.S. 50, 56 (1995). As this Court has explained:

> It is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme. A court must therefore interpret the statute as a symmetrical and coherent regulatory scheme and fit, if possible, all parts into a harmonious whole. Similarly, the meaning of one statute may be affected by other Acts, particularly where Congress has spoken subsequently and more specifically to the topic at hand.

FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 133 (2000) (internal citations and quotations omitted).

This is the same approach this Court consistently has applied in prior interpretations of the federal securities laws. *See, e.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 174-80 (1994) (analyzing numerous provisions of the 1933 and 1934 Acts in determining not to impose aiding and abetting liability under Section 10(b)); *Chiarella v. United States*, 445 U.S. 222, 234 (1988) ("the 1934 Act cannot be read more broadly than its language and the statutory scheme reasonably permit").

When read in conjunction with Section 105, the only reasonable interpretation of the loss causation requirement of section 21D(b)(4) of the Reform Act is that a plaintiff in a Rule 10b-5 action has the burden to plead and prove a causal connection between the alleged fraud and a subsequent decline in stock price. The Ninth Circuit's interpretation of loss causation here inexplicably results in two different definitions of loss causation within the Reform Act, thereby violating fundamental principles of statutory construction.[6]

Collectively, the purpose of the Reform Act, its "look back" provision, and its codification of loss causation under both Sections 21D(b)(4) and 105 provide a solid basis for developing a uniform approach to loss causation – one that requires a plaintiff to plead and prove a causal connection

6. *See Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 479 (1992) ("basic canon of statutory construction that identical terms within an Act bear the same meaning"); *see also Sullivan v. Stroop*, 496 U.S. 478, 484 (1990); *cf. United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988) ("A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme – because the same terminology is used elsewhere in a context that makes its meaning clear. . . .").

between the defendant's alleged misrepresentation or omission and the investment's subsequent decline in price. By removing the causal nexus that Congress intended to require, the Ninth Circuit's interpretation of loss causation frustrates the effective administration of the Reform Act and renders meaningless or superfluous several of its provisions.

II. An Allegation Of Price Inflation, Standing Alone, Is Not Sufficient To Satisfy The Loss Causation Pleading Requirement

As required by the Reform Act, a plaintiff who brings a securities fraud claim has the burden of proving that the alleged fraud of the defendant caused the loss for which the plaintiff seeks to recover damages. The Ninth Circuit here has held that in a fraud-on-the-market case, a plaintiff can establish loss causation simply by alleging that the stock's value at the time of purchase was artificially inflated as a result of the misrepresentation. As the court explained "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred." Pet. App. 9a. This interpretation by the Ninth Circuit essentially renders the Reform's Act codification of loss causation meaningless.

Loss causation is a screening function that serves an important purpose. It ensures the existence of an identifiable nexus between a defendant's alleged misconduct and a plaintiff's claimed losses. Consequently, it allows courts to take account of intervening factors, such as war or a recession, that may have caused the price decline, in deciding whether and to what extent to hold a defendant in a securities fraud case liable. Indeed, it is only by requiring plaintiffs to plead a specific causal nexus between the alleged fraud and a subsequent drop in stock price that courts can identify those

legitimate losses potentially stemming from fraud, while at the same time preventing the federal securities laws from turning into a system of nationwide investor insurance. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983) ("Absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission."); *cf. Raab v. General Physics Corp.*, 4 F.3d 286, 291 (4th Cir. 1993) ("The market has risks; the securities laws do not serve as investment insurance."). The Ninth Circuit's price inflation theory of loss causation offends these fundamental principles.

A. The Reform Act Clearly Intended To Codify Existing Case Law That The Misrepresentation Must Cause The Investment's Decline In Value

The Reform Act's statutory text and legislative history, as well as other provisions of the Act, support an interpretation of loss causation that requires a subsequent decline in the value of the stock causally related to the alleged fraud. For example, in discussing the loss causation requirement, the House Conference Report, issued in support of Congress's passage of the Reform Act, confirms that plaintiffs are required to plead and prove "that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff." H.R. Conf. Rep. 104-369 at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. Moreover, according to the Senate Report, the loss causation requirement was intended to reduce the cost of raising capital by "codifying the requirement under current law that plaintiff prove that the *loss in the value of their stock* was caused by the Section 10(b) violation and not by

other factors." S. Rep. No. 104-98 at 7 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 686 (emphasis added).[7]

The "current law" referenced by the Senate Report refers to a body of cases developing at least as early as 1981, and represented by *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981). In this seminal decision the loss causation requirement was found to be satisfied in a securities fraud case only if the misrepresentation caused the investment's decline in value. At trial, the judge submitted the case to the jury only on the issues of materiality and scienter. *Id.* at 539. Despite defendants' requests, the trial judge refused to submit to the jury issues relating to reliance and causation. *Id.*

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7. In discussing the loss causation provision to be included in the Reform Act, the House Conference Report states that a plaintiff must plead and prove that the misrepresentation "actually caused the loss incurred by the plaintiff. . . ." It further provides as an example that the "plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as a result of the misstatement or omission." H.R. Conf. Rep. 104-369 at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740; *See also* S. Rep. No. 104-98 at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694. Neither the House nor the Senate elaborated on the "example" provided and whether additional items of proof would be required. As the Solicitor General stated in its Brief filed in support of the petition for writ of certiorari, "it is not likely that this lone sentence in the [Reform Act's] legislative history reflects a considered congressional judgment regarding how loss causation is to be established in a Rule 10b-5 case." (SG Cert. Brief at 12) The Solicitor General concluded: "A contrary conclusion would be particularly unwarranted in view of the [Reform Act's] purpose, which was to impose strict requirement on plaintiffs in private securities fraud action." *Id.*; *see also Timbers*, 484 U.S. at 380 (generalizations contained in legislative history are inadequate to overcome the plain textual meaning contained elsewhere in the statute), and *supra* at I.A. and B.

The jury entered judgment in favor of the plaintiffs. *Id.* at 539-540.

The Fifth Circuit reversed, in part, because the district court failed to submit the question of causation to the jury. *Id.* at 549, 560. The court noted that in addition to the elements of materiality and scienter, to make a claim under Section 10(b), the plaintiff must also establish reliance and causation. *Id.* at 543. Causation, the court explained, is a related but distinct element from reliance. *Id.* at 549. Unlike reliance, which requires the plaintiff to establish that had he known the truth, he would not have acted, causation requires one step further: the plaintiff must prove that the misrepresentation directly caused his loss *Id.* The court further explained: "The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value." *Id.* at 549.

Similarly, prior to the Reform Act, the leading case in the "current law" codified by the Reform Act required plaintiffs to adequately plead loss causation in order to survive a motion to dismiss. In *Bastian v. Petron Resources Corp.*, 892 F.2d 680 (7th Cir. 1990), *cert. denied*, 496 U.S. 906 (1990), plaintiffs were investors in certain oil and gas limited partnerships. *Id.* In their complaint, plaintiffs charged that had it not been for the misleading omissions and misrepresentations made by the defendants in their offering memoranda regarding defendants' competence and integrity, plaintiffs would not have invested in the then worthless partnerships. *Id.* In granting defendants' motion to dismiss under Rule 12(b)(6), the district court held that the complaint failed to allege loss causation – i.e. that if the facts had been as represented by the defendants, the value of plaintiffs'

investment in the partnership would not have declined. *Id.* at 682.[8]

On appeal to the Seventh Circuit, plaintiffs argued that they should not be required to allege that, but for the fraud, the investment that they were induced to make would not have lost its value. *Id.* at 683. Rather, plaintiffs asserted, it was sufficient to allege simply that they would not have invested but for the fraud; that if they had not invested, they would not have lost their money; and, therefore, the fraud was the cause of their loss. *Id.* Plaintiffs admitted that they had no idea why their investment was wiped out, but argued that it did not matter since defendants' fraud induced their investment in the first place. *Id.*

In affirming the dismissal, Judge Posner noted that although plaintiffs had alleged the cause of their entering into the transaction in which they lost money – i.e. transaction causation – they had not alleged the cause of the transaction turning out to be a losing one. *Id.* at 684. According to the court, the likely reason plaintiffs were not able to allege that defendants' misrepresentations caused their loss is because the plaintiffs' investments were wiped out due to a general decline in the oil industry. As such, plaintiffs would have lost their investments in oil and gas limited partnerships despite the competency and integrity of defendants or any other management. *Id.* To award damages where plaintiffs would have lost their investment regardless of the fraud, the court explained, would result in a windfall. *Id.* at 685.

8. The district court dismissed plaintiffs' original complaint with leave to amend, but warned plaintiffs that if they alleged but later failed to prove loss causation, sanctions may be imposed. Plaintiffs filed an amended complaint, but did not reallege their Rule 10b-5 claims. The district court ultimately dismissed the amended complaint with prejudice.

In *Bastian*, Judge Posner described "loss causation" as an exotic, perhaps unhappy name. *Id.* Nevertheless, in explaining the significance of establishing loss causation in securities fraud cases, the court stated: "No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation." *Id.* Unless a plaintiff is required to plead and prove that the alleged fraud caused their loss, the trier of fact can have no confidence that the plaintiff would be better off if the defendant had refrained from making the misrepresentation. *Id.* at 686.

The Ninth Circuit's price-inflation theory of loss causation, if applied on a nationwide basis, is revolutionary and would radically alter not only how loss causation has been applied in most circuits even before the Reform Act, but also how Congress intended it to be applied under the Reform Act. There is no basis for the Ninth Circuit's rule and, thus, no reason to adopt it.

B. The Ninth Circuit's Decision Nullifies Loss Causation As An Essential And Independent Element Under Rule 10b-5

A plaintiff bringing a cause of action for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and Securities Exchange Commission Rule 10b-5 promulgated thereunder must plead and prove causation – i.e., that the defendant's alleged misrepresentation caused the plaintiff's injury. *See* 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5. Causation in this context has two elements: transaction causation and loss causation. Loss causation was first articulated as an independent and essential element in Rule

10b-5 claims by the Second Circuit in *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), where the court defined "loss causation" as a "showing" that the defendant's unlawful conduct *caused* the economic harm. *Id.* at 380 (emphasis added). The court distinguished "loss causation" from "transaction causation" which the court defined as a "showing" that the defendant's misrepresentations or omissions caused the plaintiff to "engage in the transaction in question." *Id.*

Transaction causation is frequently viewed as synonymous with reliance, and is a type of "but for" requirement: but for the defendant's fraud, plaintiff would not have entered into the transaction. *Huddleston*, 640 F.2d 534, 549. Loss causation, however, requires a critical additional step in the analysis. *Id.* As the Fifth Circuit explained in *Huddleston*: "The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss." *Id.*

As an independent element of private securities fraud claims, loss causation is entitled to meaningful application at both the pleading stage and beyond. The Ninth Circuit's price inflation theory, which does not require a subsequent decline in stock price, takes the "loss" out of "loss causation" and as such, strips the element of its intended relevance.

1. The Ninth Circuit's Price Inflation Theory Improperly Collapses Loss Causation Into Transaction Causation

The Ninth Circuit here appeared to acknowledge that loss causation and transaction causation are distinct and independent elements of a Rule 10b-5 claim. Pet. App. 8a.

The result reached in the Ninth Circuit's holding, however, inexplicably merges loss causation into transaction causation, thereby denying the former the independent purpose it should serve in a fraud-on-the-market case such as this one.

As decided by this Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), under certain circumstances, the fraud-on-the-market theory entitles plaintiffs to a rebuttable presumption of reliance (or transaction causation) in claims brought under Rule 10b-5. *Id.* at 245-49. The rationale supporting the presumption is that efficient, well-developed capital markets rapidly reflect all publicly available information, including any material misrepresentations, into the price of securities at the time of investment. *Id.* at 246. Accordingly, "[b]ecause *most publicly available information* is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247 (emphasis added). Nothing in *Basic* supports what the respondents tried to do here: seek recovery for a decline that occurred *before* any corrective disclosure became "publicly available." Presumably, under the efficient market theory a security's price decline does not reflect the market's reaction to information that was allegedly concealed until after the decline.

Under the Ninth Circuit's view, however, a plaintiff sufficiently pleads loss causation if he alleges that the price of stock on the date of purchase was inflated a result of a misrepresentation. Pet. App. 9a. This, however, is nothing more than a restatement of the presumption of reliance – i.e., transaction causation – adopted in *Basic*. Under the efficient market theory, a material misrepresentation or omission which reflects favorably on a company will typically inflate that company's stock price. Consequently, if, under the Ninth Circuit's approach, a plaintiff invoking the fraud-on-the-market

theory need only allege a material misrepresentation or omission and artificial inflation of the stock price, the plaintiff will simultaneously satisfy the pleading requirements for both transaction causation and loss causation based upon the same "presumption," thereby improperly conflating the two.

There can be no presumption of loss causation, whether under *Basic* or otherwise, because the Exchange Act expressly provides that "plaintiff shall have the *burden of proving* that the act or omission of the plaintiff caused the loss." 15 U.S.C. § 78u-4(b)(4) (emphasis added).[9] Accordingly, most courts properly have refused to collapse loss causation into *Basic*'s presumption of reliance or transaction causation. *See Emergent Capital*, 343 F.3d at 198 (alleging a disparity in investment value at the time of purchase is, by itself, nothing more than a paraphrased allegation of transaction causation); *AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 216 (2d Cir. 2000) ("Loss causation is a separate element from transaction causation and . . . loss causation cannot be collapsed with transaction causation."); *Robbins*, 116 F.3d at 1448 (refusing to use *Basic*'s presumption of reliance "to alter the loss causation requirement" because that theory "is used to support a rebuttable presumption of reliance, not a presumption of causation."); *cf. Huddleston*, 640 F.2d at 547 (it is "a nonsequitur to conclude that the representation that induced action necessarily caused the consequences of that action.").

9. Notably, prior to the adoption of the Reform Act and its codification of loss causation, members of Congress expressed concern that some courts were adopting a presumption of loss causation, as well as reliance, in fraud-on-the-market cases. *See* Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 Fordham L. Rev. 1781, 1811 n.273 (April 2000) (*citing* Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, Staff Report on Private Securities Litigation 228 (May 17, 1994) (prepared at the direction of Sen. Dodd)).

2. The Ninth Circuit's Interpretation Of Loss Causation Is Counterintuitive To The Efficient Market Theory

The Ninth Circuit's approach regarding loss causation simply cannot be reconciled with the fundamental premise underlying the fraud-on-the-market theory – the efficient market theory. Under the efficient market theory, if a stock price is inflated as the result of a material misrepresentation disseminated to the investing public, such inflation will necessarily carry over until the true facts are revealed through a corrective disclosure. It is at this point that the market will correct itself and the price of the stock will decline. As explained by the Third Circuit in *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3rd Cir. 2000):

> Where the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation. In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.

Id. at 185. Accordingly, an investor in a fraud-on-the-market case who purchases a security at an artificially inflated price cannot be said to have suffered any economic loss as a result of the alleged misrepresentation until the "truth" is disclosed and absorbed by the efficient market thereby causing the stock price to drop.

If the fraud-on-the-market theory is going to have any principled consistency, loss causation based on a price decline in response to disclosure of the alleged fraud is a necessary element of a fraud-on-the-market case. Since plaintiffs have the benefit of the efficient market theory to obtain a presumption of transaction causation, they should not be allowed to ignore or contradict the logical consequences of that theory when it comes to their obligation to plead and prove loss causation. Defining loss causation in terms solely of artificial inflation at the time of purchase, as the Ninth Circuit here has done, divorces "loss causation" from the reality of the market's response and renders its application meaningless.[10]

C. The Ninth Circuit's Reliance On A Price Inflation Theory To Satisfy Loss Causation Contravenes Established Tort Principles

As illustrated in *Central Bank*, this Court has been unwilling to interpret the judicially-implied private right of action under Section 10(b) as broadly as the common law.[11] *Central Bank*, 511 U.S. at 180. In particular, here Congress has itself defined "loss causation" to require "depreciation in value resulting from" the specific misstatement. 15 U.S.C.

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10. Petitioners respectfully refer the Court to the Amicus Brief of the Securities Industry Association, *et al.* It contains a fuller explanation of how the Ninth Circuit's loss causation rule contradicts *Basic* and the efficient market hypothesis. It also explains more fully the adverse implications for the securities markets, market participants, and investors from the Ninth Circuit's loss causation rule.

11. For a full discussion of how this Court has repeatedly limited the scope of liability under Section 10(b), petitioners respectfully refer the Court to the Amicus Brief of Merrill Lynch & Co., Inc.

§ 77*l*(b); *see supra*, at I.B. Thus, there is no reason to look to the common law for a definition that Congress itself provided. There are no statutory interstices to fill. Even assuming for the sake of argument, however, that common law proximate causation principles were relevant to defining loss causation under Section 10(b), those principles also require that a specific misrepresentation cause not merely a plaintiff to buy a security, but also a specific subsequent decline in the security's price.

Both Prosser, Law of Torts[12] and the Restatement (2d) of Torts show this. These authorities illustrate that there is no liability when the value of stock declines, not as a result of the misrepresentation which induced the transaction in the first place, but rather as a result of other factors in no way related to the fraudulent misrepresentations.[13]

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12. *See* W. PROSSER & W. KEETON, PROSSER AND KEETON ON TORTS ¶ 110, at 767 (5th ed. 1984):

> . . . if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline of the market, or insolvency of the corporation, brought about by business conditions or other factors in no way related to the representations, will not afford any basis for recovery.

13. As the Restatement (2d) of Torts points out, one who misrepresents the financial condition of a company in order to sell stock will be liable to the purchaser who relies on the misrepresentation for the losses incurred when the facts regarding the company's finances are disclosed and the stock subsequently declines in value. However,

> there is no liability when the value of the stock goes down after the sale, not in any way because of the

(Cont'd)

The following hypothetical from the Restatement (2d) of Torts is particularly helpful

> A, seeking to sell to B the municipal bonds of C County, fraudulently tells B that the county has received full payment for the bond issue. B purchases the bonds in reliance upon this statement. Subsequently, the county is paid in full, but the bonds are held void by the supreme court of the state on the ground that the court had no jurisdiction to issue certain orders with respect to them. As a result B suffers pecuniary loss. A is not liable to B for the loss.

RESTATEMENT (SECOND) OF TORTS § 548A cmt. b, illus. 1 (1977). Under this scenario, it would not be enough to allege that the price of the bonds was artificially inflated as a result of A's misrepresentation about full payment. The misrepresentation was not the cause of the subsequent decline in the value of the bonds, and thus, the failure to establish causation precludes recovery.

(Cont'd)

> misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition. There is, for example, no liability when the shares go down because of the sudden death of the corporation's leading officers. Although the misrepresentation has in fact caused the loss, since it has induced the purchase without which the loss would not have occurred, it is not the legal cause of the loss for which the maker is responsible.

RESTATEMENT (SECOND) OF TORTS § 548A cmt. b (1977).

D. The Ninth Circuit's Price Inflation Theory Creates A Potential Windfall For Certain Investors

The potential consequences of allowing a plaintiff to pursue a securities fraud claim based on an allegation of price inflation alone cannot be ignored. Notably, the price-inflation theory of loss causation has the potential to allow plaintiffs to satisfy the pleading requirement for loss causation even where they have suffered no loss. Take, for example, an "in-and-out" investor, who both purchases and sells his stock at an inflated price. Suppose that the amount of inflation is constant and that this investor bought a share of stock for $50, which in reality was worth only $10, but also sold that share of stock at $50, thereby breaking even in the process. Under the Ninth Circuit's interpretation of loss causation, a plaintiff need only allege price inflation at the time of purchase. Because the Ninth Circuit does not require a subsequent decline in stock price, the in-and-out investor plaintiff could satisfy the loss causation pleading requirement by simply alleging that the stock was overpriced by $40 at the time of purchase, even though the investor suffered no loss. As the Third Circuit recognized in *Semerenko*, "[i]n the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price." 223 F.3d at 185. Accordingly, the Ninth Circuit's price inflation theory of loss causation has the potential to create a windfall for in-and-out investors and others.

III. Respondents' Anticipated Alternative Theories Of Loss Causation Are Unsustainable

Respondents may argue that the November 3, 1998 price decline – nine months after the February 24, 1998 termination of the Class Period – is somehow relevant to establishing loss causation here. To this point, however, respondents' theory of loss causation has been focused purely on an allegation of price inflation at the time of purchase. Respondents have rejected any notion that the loss causation analysis must be based on a subsequent change in the stock's price. *See* JA 205a ("Under this [Ninth] Circuit's law . . . [t]he correct focus is on the stock's inflation at the moment of purchase – not on its price at some later time.").

Nowhere in either the Consolidated Amended Complaint or the operative Second Amended Complaint do respondents even allege the November 3, 1998 price decline. *See* SER 37, JA 34a-141a. Similarly, respondents did not address the November 3 price decline anywhere in their opposition to defendants' motion to dismiss plaintiffs' Second Amended Complaint. (*See* U.S. District Court, Southern District of California, Civil Docket for Case #: 99-CV-151, docket number 83). The district court's grant of a Rule 12(b)(6) dismissal could not be reversed – either by the Ninth Circuit or this Court – based on an allegation and argument never made in the district court.

In fact, the only mention respondents make of this price decline is a cursory reference to it in their Opening Brief to the Ninth Circuit. JA 208a. Even then, respondents neither argued that it was a loss for which they ought to recover, nor did they assert it as a basis for establishing loss causation. *See* JA 204a-208a.

The reality is that the November 3, 1998 price decline is irrelevant to respondents' claims. A plaintiff who brings a securities fraud claim "shall have the burden of proving that the act or omission of the defendant alleged to violate [the Exchange Act] *caused the loss for which the plaintiff seeks to recover*." 15 U.S.C. § 78u-4(b)(4) (emphasis added). This requirement applies equally at the pleading and proof stages. Respondents' Class Period ends on February 24, 1998. JA 34a: ¶ 1. The "loss" for which respondents sought to recover in the district court and court of appeals is that associated with the 47% price decline that occurred between February 24, 1998 and February 25, 1998. JA 34a-141a: ¶¶ 32, 39, 134, 172. Not surprisingly, respondents strategically elected to end their Class Period on February 24, 1998, with the 47% price decline, and not nine months later, with the temporary 21% price decline, where the shares immediately rebounded. *See supra*, at Statement of the Case. In short, because the November 3, 1998 price decline bears no relationship to respondents' stated class period and the associated loss for which respondents sought to recover, it is irrelevant to their claims.

Respondents may also argue that a decline in stock price is not necessary to establish loss causation, such as in a case where the disclosure of negative and positive information results in an overall net increase in stock price and thus a masking of the reduction in price caused by the negative disclosure. Even apart from the inherent speculation in such an argument, such a hypothetical case has no application here because respondents have not alleged a post-disclosure price reduction masked by other positive information. Instead, respondents sought to recover losses for the February 25, 1998 decline in stock price, which, by their own admission, is not causally related to any representations regarding

Albuterol Spiros. As discussed above, respondents' theory of loss causation has always been based purely on alleged inflation at the time of purchase without a subsequent decline in stock price at any time – whether masked or otherwise. *See* JA 205a ("The correct focus is on the stock's inflation at the moment of purchase – not on its price at some later date."). Moreover, even where a decline in stock price is masked by the simultaneous disclosure of positive and negative information, in order to properly plead loss causation, a plaintiff must still allege a causal connection between the alleged fraud and an actual reductive effect in the price of the stock from what it otherwise would have been.

CONCLUSION

For the foregoing reasons, petitioners respectfully request that the Supreme Court reverse the Ninth Circuit decision below with respect to respondents' claims regarding Albuterol Spiros.

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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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QUESTION PRESENTED

Whether to plead loss causation in a Section 10(b) open-market fraud case plaintiffs must do more than plead facts establishing fraud-based inflation and overpayment on the date of their purchase.

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STATEMENT OF THE CASE

This is a securities class action filed on behalf of investors who purchased Dura Pharmaceuticals securities between April 15, 1997, and February 24, 1998 (the "Class Period").[1] Petitioners before this Court, and defendants below, are Dura and several of its top officers (collectively "Dura"). JA60a-63a (¶¶48-50). Respondents, plaintiffs below, allege that Dura made misleading statements to securities analysts and investors on two subjects: (1) sales of Dura's "Ceclor CD" antibiotic product, and (2) the status of its new "Albuterol Spiros" ("AlSpiros") device for delivering Albuterol asthma medicine. JA34a-58a (¶¶1-39). Defendants' misstatements, the plaintiff investors contend, inflated the price of Dura securities through the Class Period (and after), causing them to overpay when they purchased those securities. JA55a (¶37), 58a (¶39), 139a (¶179).

The operative complaint pleads with particularity how Dura falsely represented that Ceclor CD antibiotic sales were increasing—when in truth, Dura knew they were dropping. JA48a-52a (¶¶26-34). Specifically, Ceclor CD sales began to drop around March and April 1997 (from 47,288 units in March to 39,808 in May), falling nearly 50% by midsummer (to 24,797 units in July). JA70a-71a (¶63). Dura nonetheless publicly asserted Ceclor CD sales were strong, falsely reporting increased market share by comparing Ceclor CD, not to the entire class of respiratory antibiotics, but to generic Ceclor products. JA49a (¶28). By late 1997, Dura's sales channels were jammed with many months of unsold inventory, versus the normal one-month supply. JA50a (¶30), 110a (¶135). In December of 1997 Dura began to offer a 5% price reduction to wholesalers, trying to get them to take still more.

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[1] JA34a, *et seq.*; *see* JA59a-60a (¶¶41-47) (lead plaintiffs' individual purchases), JA138a-139a (¶¶172-177) (class allegations). The Joint Appendix is cited herein as "JA," and the Certiorari Petition's Appendix is cited as "PA."

JA49a-50a (¶29). Not until early 1998 did Dura belatedly admit to the drop-off in Ceclor CD sales, the clogged sales channels, and the need to hire hundreds of additional sales personnel to move the product and salvage sales. JA51a (¶32), 109a-110a (¶¶134-135).

Dura also falsely represented that completed tests showed its new AlSpiros drug-delivery system, designed to aerosolize a powdered form of the asthma drug Albuterol so that it could be inhaled easily, was effective and poised for Food & Drug Administration ("FDA") approval. JA35a(¶2), 76a-78a (¶¶72-76). In truth, clinical trials and in-house testing had shown that the device was fatally flawed—it never worked properly. JA37a-43a (¶¶7-17), 45a-47a (¶¶22-24), 51a-53a (¶¶33, 35). Dura's top engineers recommended that Dura not proceed with scheduled Phase III clinical trials, let alone file a New Drug Application ("NDA") with the FDA, until the known reliability and stability problems were resolved. JA37a-38a (¶8), 40a (¶11). But Dura's top executives ignored their warnings.[2] During its clinical trials AlSpiros experienced a failure rate exceeding 30%, versus an industry target of less than 1%. JA40a-41a (¶¶11-12), 73a (¶68).

Dura nonetheless told the investing public that it was successfully executing on its AlSpiros drug-delivery technology, and was pleased with the results. *E.g.*, JA45a (¶21), 66a-67a (¶56). This was utterly false. JA72a-74a (¶¶66-70). Even following the disastrous Phase III clinical trials—in which the product had to be modified several times—Dura never

[2] JA40a (¶11), 74a (¶70). In October 1996, Dura's Vice President of Product Development, Robert Eisele, authored an internal report (the "Eisele List") examining and explaining the existing problems with the AlSpiros product. AlSpiros, the report noted, was incapable of consistently delivering the required drug dosage or of withstanding normal use conditions, and its cassette system suffered from instability. JA37a-39a (¶¶8-9). These problems persisted throughout the Phase III final clinical trials despite several modifications. JA39a-43a (¶¶10-17).

managed to solve its stability problems and eventually had to abandon AlSpiros. JA41a-43a (¶¶14-17), 53a (¶35).

Why the misrepresentations? Dura's original business strategy had been to sell niche-market pharmaceutical drugs. JA34a-35a (¶1). By 1995, seeing that it would be increasingly difficult to sustain revenue and earnings-per-share ("EPS") growth solely by securing rights to market niche drugs, management decided to change course. *Id.* Dura would become a *medical-device* company, developing and marketing its own proprietary products. *Id.* Because this metamorphosis would cost millions of dollars—and to avoid a huge negative impact on its reported earnings—Dura's management created Spiros Development Corp. (or "Spiros I") in December 1995, to incur Dura's costs of developing the Spiros drug-delivery system. JA36a (¶¶4-5), JA44a (¶¶18, 20).

By the spring of 1997 the securities market clearly understood that AlSpiros was critical to Dura's future. JA76a-78a (¶¶73-76). Without AlSpiros, said securities analysts, Dura would be "strictly" a specialty-drug marketing company, limited to selling "niche respiratory product lines." JA76a-77a (¶73). AlSpiros was what "differentiates Dura," because it would "provide an important growth catalyst" and add an anticipated $58 million to Dura's sales in 1999, then $100 million in 2000. JA76a-77a (¶73), 78a (¶76).

So, starting in April 1997 through December 1997, defendants began to crow about Ceclor CD sales and AlSpiros—falsely stating that Ceclor CD sales were strong and gaining market share, and that AlSpiros was a "durable" product that "can deliver a consistent dose," *i.e.*, that it worked and was efficacious. JA65a-67a (¶¶55-56). As a consequence, Dura's stock rose from $27-7/8 in April to $44-7/8 by mid-July 1997. JA45a (¶21), 67a (¶57), 81a (¶84). Taking advantage of the inflated price, Dura on July 25, 1997, accomplished a $287.5 million convertible-note offering—its largest securi-

ties offering ever. JA92a (¶102). Two lead plaintiffs purchased 65 of those notes, at over $1,000 apiece. JA60a (¶¶45-46). Dura insiders unloaded nearly 190,000 of their own common-stock shares for $7 million in proceeds. JA120a-122a (¶154).

Throughout the fall of 1997, Dura continued to issue positive statements about Ceclor CD sales, and bragged that AlSpiros development was on track for commercial sales beginning in 1998. JA92a-96a (¶¶103-112), 101a-103a (¶¶122-123). As a consequence, Dura's stock price climbed still further, to $52-1/4 on October 8, 1997—an all-time high. JA94a (¶107). Two days later, Dura announced it was going to exercise its option to buy Spiros I's stock using Dura stock, and would launch a successor company—"Spiros II"—via a sale of units to the public that would include warrants to buy the high-flying Dura stock. *Id.* Within a few days, on October 14, 1997, Dura reported record earnings attributing ostensibly strong pharmaceutical-sales growth to several factors, including excellent Ceclor CD sales. JA95a-96a (¶111).

With Dura's stock price high, individual defendants again sold personal stock holdings, collecting another $9.2 million.[3] And on December 17, 1997, Dura and Spiros II successfully completed the Spiros II offering, selling 5.5 million Spiros II units (at $16 each) for $88 million. JA103a (¶124).

On February 24, 1998, within weeks of the offering and insiders sales, Dura shocked investors by admitting that Ceclor CD sales were far weaker than previously represented, and that trying to boost sales would require expanding its sales force by 66%, at great expense. JA51a (¶32), 109a-110a (¶134).

[3] JA105a (¶127), 120a-122a (¶154). Defendant, and former FDA employee, Prettyman, head of Dura's Regulatory Affairs Department, argued against submitting the AlSpiros NDA to the FDA, but when overruled he sold 15,000 shares at $48-1/2 for over $728,000 on November 5—just five days before his department filed the NDA. JA103a (¶123), 105a (¶127).

Dura's stock price dropped 47% in a day, from a high of $39-1/8 on February 24 to a low of $20-3/4 on February 25, on an unprecedented 32-million-share trading volume. JA51a (¶32). The stock tumbled another 40% in the ensuing months as Dura's business performed miserably, with poor earnings and lower-than-expected sales. *See* JA52a-53a (¶34), 110a (¶135), 54a (¶36) (stock chart); "Dura Warns on Profit, Teams Up With Lilly on Insulin," *Bloomberg News*, Sept. 23, 1998 (described in Respondents' November 17, 2004, letter).

In early November 1998, in a press release that misleadingly downplayed the ruling's significance, Dura revealed that the FDA had rejected its AlSpiros NDA. JA110a-111a (¶136). Dura's stock dropped another 20%. *See* JA156a.

When the FDA issued a notice of violation to Dura three days later, charging that the company's press release itself had "'*misleadingly minimize[d] the fact that Dura must conduct a completely new clinical data [study]*,'" Dura quietly removed the misleading press release from its website. JA111a (¶136); *see* November 6, 1998, FDA warning letter to Dura. (described in Respondents' November 17, 2004, letter).

Notably, the FDA denied Dura's application for the very reasons that an internal Dura document (the Eisele List) had catalogued *before* the Class Period in October 1996, showing that the device was neither reliable nor stable. JA110a-111a (¶136). These were the very reasons that made Dura's engineers advise management not to proceed. JA37a-39a (¶¶8-9), 40a (¶11), 74a (¶). The defects were so severe that Dura ultimately abandoned its attempts to develop the AlSpiros system—it was never proved to be reliable or efficacious. JA53a (¶35), 111a (¶136).[4]

[4] While Dura's stock price rebounded with the entire pharmaceutical sector in the weeks following the AlSpiros disclosure, it never recovered to half of its Class Period highs exceeding $50. *See* comparison chart that

Investors who had purchased Dura securities at inflated prices filed suit on January 27, 1999, alleging securities fraud and proposing a Class Period that closed with Dura's first negative revelation centering on Ceclor CD. Following amendments the district court dismissed plaintiffs' Second Consolidated Amended Complaint ("SAC") with prejudice and entered judgment, holding that plaintiffs had not pleaded facts raising a strong inference of scienter regarding false statements about Ceclor CD. PA45a-47a. The court further held that because Dura had not mentioned the AlSpiros device in the press release about poor Ceclor CD sales, on which Dura stock dropped 47% at the Class Period's close, plaintiffs had not sufficiently pleaded that false statements about AlSpiros had caused them any loss. PA34a-40a.[5]

Plaintiffs appealed, arguing that the district court had erred in ruling that they could neither plead scienter as to statements about Ceclor CD sales, nor loss causation as to the false AlSpiros statements.

The Ninth Circuit reversed. PA1a-17a. As to Ceclor CD, the Ninth Circuit found that the district court had erred in considering the allegations separately rather than as a whole and directed the district court to consider allegations about

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is described in Respondents' November 17 letter. To be sure, the rebound cut potential damages at the end of an extended Class Period but certainly not by much, as the mean trading price for the 90-day statutory look-back was $12.96. *See* JA154a-156a; *see* stock-price chart compiled from the Complaint's allegations, appended to the end of this brief.

[5] The failure of Dura's sales force, due to a lack of necessary sales agents to execute on Ceclor CD sales, however, necessarily meant the same for AlSpiros—for the two were inextricably linked. JA48a (¶26). The continuing cost of upgrading Dura's sales force, the market would have understood, applied to all of Dura's products. *See, e.g.*, "Dura Shares Plunge on Profit Warning, Slow Drug Sales," *Bloomberg News*, Feb. 25, 1998 ("higher sales costs" to affect profits as "Dura will boost its sales force to 450 from 270 this year as it prepares to start sales of its Spiros inhaler in 1999")

Ceclor CD's market share, strength of sales, channel stuffing, and insider sales—as well as any additional allegations from confidential witnesses about manipulating analysts and one defendant's oft-stated phrase "let' em catch us"—in conjunction with one another in evaluating whether plaintiffs had pleaded facts raising a strong inference of scienter. PA14a-15a. As to AlSpiros, the Ninth Circuit followed decades of precedent to hold that loss causation does not in every case require "a disclosure and subsequent drop in the market price of the stock . . . because the injury occurs at the time of the transaction." PA9a. "It is at this time that damages are to be measured." *Id.* Finally, the Ninth Circuit could find no reason to limit amendment on remand to the Ceclor CD allegations. PA15a-16a & n.6.

SUMMARY OF THE ARGUMENT

Dura challenges Ninth Circuit precedent holding that "'in a fraud-on-the-market case plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.'" PA9a (quoting *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996) (Wallace, J., for the court)). Under Ninth Circuit law, "for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock actually occurred, because the injury occurs at the time of the transaction." *Id.* Dura asserts this long-standing rule of law is wrong, and that investors who paid too much for an inflated security must connect a later stock drop to a curative disclosure in order to plead loss causation—no matter the initial overpayment.

Dura's position conflicts not only with established Ninth Circuit precedent, but also with the Private Securities Litigation Reform Act of 1995 ("PSLRA"), this Court's opinions on causation, and common-law proximate-cause principles. All have long identified the loss most proximately and directly caused by fraud as the difference between price

and value on the date of purchase—not some later decline in price.

Applying the common-law fraud rule, this Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972), determined that in §10(b) cases the proper measure of recovery is the difference between the transaction price and the value—also known as "out-of-pocket" loss. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1998), this Court reiterated that the relevant causal link in cases of open-market fraud and price manipulation is that between defendants' misrepresentation and resulting transaction price. *See id.* at 243, 248.

Consistent with this Court's decisions, when Congress amended the 1934 Act in 1995 to codify standards for the §10(b) cause of action, it provided that investors who manage to plead evidentiary facts both demonstrating false statements and raising a strong inference of fraudulent intent—with the particularity required to survive heightened pleading standards on a motion to dismiss—then "shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. §78u-4(b)(4). "For example," the legislation's Conference Report and Senate Report both explain, "*the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.*" H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740 (emphasis added); S. Rep. No. 104-98, at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694. Thus, under the PSLRA, investors prove a recoverable loss by showing that a defendant's scienter-laden false statement inflated the price they paid. *See id.*

This standard—which effectively codifies the traditional rule that the loss proximately caused by fraud affecting an investment decision amounts to the difference between price and value at the time of the transaction—produces no "windfalls" or "double recoveries." Just the opposite. "If the stock is resold at an inflated price, the purchaser-seller's damages, limited by §28(a) of the Act, 15 U.S.C. §78bb(a), to 'actual damages,' must be diminished by the inflation he recovers from his purchaser." *Blackie v. Barrack*, 524 F.2d 891, 908-09 (9th Cir. 1975); *see Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 & n.4 (9th Cir. 1987); *Green v. Occidental Petroleum*, 541 F.2d 1335, 1345-46 (9th Cir. 1976) (Sneed, J. concurring). The rule has served well for decades.

From a practical standpoint, the rule now urged by Dura—requiring a corrective disclosure linked to a stock-price drop—would be disastrous both for investors and the integrity of our securities markets. Under the PSLRA defrauded investors must already plead with particularity facts demonstrating a material misrepresentation or omission, which caused the stock to be inflated when purchased. *See* 15 U.S.C. §78u-4(b)(1). They must also set forth specific facts raising not merely a reasonable inference, but a *strong inference*, of scienter. *See* 15 U.S.C. §78u-4(b)(2). Were investors required to also plead subsequent disclosures of the fraud by confession or otherwise, linking these disclosures to a drop in the price of the stock, the additional hurdles could often be insurmountable. The reasons are not complex.

Market valuations are based upon expected future cash flows discounted by the cost of capital, commonly referred to as discounted cash flows.[6] Open-market frauds manipulate

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[6] *See* Burton G. Malkiel, *Is The Stock Market Efficient?*, 243 Science 1313, 1316 (Mar. 10, 1989); Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. Bus. 411, 415-16 (1961); Richard A. Brealey & Stewart C. Myers, *Capital Investment and Valuation* 77 (2003); R.A. Brealey, *An Introduction to Risk and Return From Common Stock* 67-72, 78 n.1 (2d ed. 1983); Eugene F. Fama & Merton H. Miller, *The Theory of Finance* 87-89 (1972); *see also* Jay W. Eisenhofer, Geoffrey C. Jarvis & James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a*

stock-market prices by artificially raising cash-flow expectations. Sophisticated individuals who would commit market manipulation and fraud are likely to be adept at concealing it. Expectations can be lowered, thereby reducing fraud-induced inflation without disclosure of the fraud, by further false statements.[7] Even the passage of time itself will dissipate a fraud's impact on a stock's price.[8] On Dura's theory, simply concealing the fraud would reduce the recoverable loss—not the loss actually suffered. And once expectations are lowered, even if the full extent of the fraud is then revealed, its disclosure's impact on a stock's price could be negligible.

Congress recently extended the statue of repose for §10(b) actions from three to five years with the passage of the Sarbanes-Oxley Act in 2002 in order to enable private investors more time to uncover and pursue securities fraud. *See* Pub. L. No. 107-204, §804(a), 116 Stat. 801 (July 30, 2002), adding 28 U.S.C. §1658(b)(2). Co-sponsor Senator McCain explained that "the worst offenders may avoid accountability and be rewarded if they can successfully cover up their misconduct for merely three years. The more complex the case, the easier it will be for these wrongdoers to get away

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Corporate Finance-Based Theory of Loss Causation, 59 Bus. Law. 1419, 1421-24 (2004).

[7] *See* Eisenhofer, *supra*, 59 Bus. Law. at 1443.

[8] Inflation due to an earnings misstatement ages over time, as does inflation from sales or asset overstatements. *See* Marcia Kramer Mayer, Ph.D., *Loss Causation and Damages: Dura and Beyond*, NERA Economic Consulting (Sept. 30, 2004) ("NERA Presentation," described in Respondents' November 17 letter); *see also In re Initial Pub. Offering Sec. Litig.*, 297 F. Supp. 2d 668, 673 (S.D.N.Y. 2003) ("*IPO*") ("ordinary market forces affect the rate of artificial inflation" because in some circumstances "the normal functioning of the securities market causes the inflationary effect to dissipate over time"); A.A. Berle, *Liability For Stock Market Manipulation*, 31 Colum. L. Rev. 264, 269 (1931) ("a false statement . . . some years ago would have little appreciable effect on the price of the stock today").

with fraud." 148 Cong. Rec. S6528-29 (July 10, 2002).[9] The ability to conceal and the passage of time should not relieve those who commit securities fraud because the inflationary effects of their fraud have dissipated during the five years that Congress has now given investors to uncover and pursue. *See* 28 U.S.C. §1658(b)(2).

In addition, a complex scheme's impact on a company's stock price necessitates expert analysis to eliminate market variables and isolate company-specific information, which may require an event study with regression analysis, and even discovery, for a full understanding of the scheme, its scope, and duration.[10] With the PSLRA's automatic stay of discovery until *after* a determination on the pleadings, *see* 15 U.S.C. §78u-4(b)(3)(B), such a full analysis may simply be impossible to perform at the pleading stage. It is better left for proof, per the statute, at summary judgment or trial.

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[9] In cases such as *Enron*, *Worldcom*, *Qwest*, *Healthsouth*, and other recent disasters, where Respondents' counsel's clients include some of the largest public and private funds in the world such as the California Public Employees' Retirement System, Central States, Southeast, and Southwest Areas Pension Fund (Teamsters), Northwestern Mutual, The Regents of the University of California, Western Conference of Teamsters Pension Trust Fund, as well as the state retirement funds of Alaska, Idaho, Maine, New Hampshire, New Mexico, Ohio, Tennessee, Washington and West Virginia, the full extent of the fraud or each participant's role (including the accountants, bankers, and lawyers) was not revealed until long after these stocks collapsed. Were the rules urged by Dura and its *amici* adopted, any meaningful recovery to the beneficiaries of these funds could be effectively denied.

[10] On the necessity of expert analysis and event studies in calculating inflation resulting from fraud while excluding other market variables, *see* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 17-19 (1982); Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud in the Market Cases*, 37 U.C.L.A. L. Rev. 883, 897-911 (1990); Eisenhofer, *supra*, 59 Bus. Law. at 1424-28, 1444-45.

The present case illustrates the problems that may be encountered. On the disclosure of poor Ceclor CD sales the stock price dropped 47%, but this disclosure—aside from being months late and after significant insider sales—included no disclosure about Dura's AlSpiros reliability problems, which had been fully documented within Dura the year before.[11] The stock tumbled another 40% in the ensuing months as Dura's business continued to deteriorate. By the time of the belated November 1998 AlSpiros announcement, Dura's stock had already been crushed—but it still dropped another 20% on the news. *Even then* defendants continued to mislead the investing public by minimizing the device's failure, causing the FDA to issue a notice of violation. Dura quietly removed the press release from its website, but it did not disclose the truth. Ultimately, the product's problems were insurmountable, causing the company to abandon its further development.

ARGUMENT

I. PRE-PSLRA SUPREME COURT AND CIRCUIT DECISIONS ESTABLISHED LOSS CAUSATION PRINCIPLES FOR §10(b) CASES: THE INVESTOR'S LOSS IS PAYING A FRAUD-INFLATED PURCHASE PRICE

Dura, and the United States as *amicus curiae*, say that "when Congress passed the PSLRA, loss causation was generally recognized as a judicially inferred element of a Rule 10b-5 cause of action. The PSLRA codified the loss-causation requirement, making it a statutory element." U.S. Brief at 10. Yet, the loss-causation precedents that Dura and its *amici* say Congress codified—such as *Robbins v. Koger Props.*, 116 F.3d 1441, 1448 (11th Cir. 1997), *Semerenko v.*

[11] The disclosure did, however, have an impact on the costs of sales associated with the expected AlSpiros release, as picked up by the market. *See* n.5, *supra*.

Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) (dictum), and *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group*, 343 F.3d 189, 198 (2d Cir. 2003) (dictum)—actually postdate the 1995 legislation.

While it is wholly proper "to look to 'the state of the law at the time the legislation was enacted,'" *Randall v. Loftsgaarden*, 478 U.S. 647, 663 (1986) (citation omitted), Congress in 1995 could not possibly have intended to codify these *later* decisions' gloss on loss causation. What Congress knew and codified were earlier holdings—that the recoverable loss proximately caused by fraud is the difference between price and value on the date of purchase, not some later decline in price. That was the common-law rule, codified in §9(e) of the 1934 Act, 15 U.S.C. §78i(e), adopted for §10(b) actions, and applied by this Court in its major securities-fraud precedents. It is the law under §21D(b)(4). *See Midlantic Nat'l Bank v. New Jersey. Dep't of Envtl. Prot.*, 474 U.S. 494, 501 (1986) ("The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific.").

A. Under the Common Law of Deceit and Market Manipulation an Investor's Loss Is the Difference Between the Fraud-Inflated Price Paid and Value on the Date of the Transaction

Rule 10b-5 is "distinct from common-law deceit and misrepresentations" because it was "in part designed to add to the protections provided investors by the common law." *Basic*, 485 U.S. at 244 n.22. Nonetheless, as the United States observes, courts properly look to common-law doctrines "in deciding what elements a Rule 10b-5 cause of action comprises, and what must be pleaded and proved to establish them." U.S. Brief at 10. "That is certainly true of loss causation." *Id.* at 10-11. "As Judge Posner has observed, 'what securities lawyers call "loss causation" *is* the standard common law fraud rule ***, merely borrowed for

use in federal securities fraud cases.'" *Id.* at 11 (quoting *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 683 (7th Cir. 1990) (Posner, J., for the court)); *accord*, *e.g.*, *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997) (§10(b) "loss causation" is "nothing more than the 'standard common law fraud rule'").

The common-law rule was well-established preceding passage of the Securities Exchange Act of 1934. This Court held in *Sigafus v. Porter*, 179 U.S. 116, 122-26 (1900), that when one induced by misstatements (or omissions) to make an investment overpays, the core loss proximately caused by the fraud is suffered at the time of the initial purchase—by paying more than the investment was then worth. It is "'the difference between the real value of the stock at the time of sale and the fictitious value at which the buyer was induced to purchase.'" *Id.* at 124 (quoting *High v. Berret*, 148 Pa. 261, 264, 23 A. 1004 (1892)). This is the common-law fraud rule: "In an action based upon fraud the purchaser is entitled to recover his actual loss measured by the difference between the price he paid and the value of that which he received, determined as of the time of the transaction." *Kaufman v. Mellon Nat'l Bank & Tr. Co.*, 366 F.2d 326, 331 (3d Cir. 1966).

Section 10(b)'s other parent, the common law of market manipulation, similarly saw investors' loss in the payment of an inflated price. Holding in *McMullen v. Hoffman*, 174 U.S. 639 (1899), that an anticompetitive bid-rigging contract is against public policy, this Court observed that *Rex v. De Berenger*, 3 M. & S. 67, 72, 105 Eng. Rep. 536 (1814), had addressed a plot "'by false rumors to raise the price of the public funds and securities.'" *McMullen*, 174 U.S. at 649 (quoting *De Berenger*, 3 M. & S. at 72-73 (cited in *Scott v. Brown*, 2 Q.B.D. 724, 730 (1892))). Such conduct, it said, "'strikes at the price of a vendible commodity in the market, and if it gives it a fictitious price by means of false rumors, it

is a fraud leveled against all the public, for it is against all such as may possibly have anything to do with the funds on that particular day.'" *Id.* The injury to public investors was in paying a fictitious or fraudulent price.[12]

The rule is a very conservative one, denying defrauded investors the right to recover the expected benefit of their bargain. *See Sigafus*, 179 U.S. at 123; *Smith v. Bolles*, 132 U.S. 125, 129-30 (1889). And while victims of other types of fraud generally may recover not only the difference between price paid and value received, but also further consequential damages,[13] investment-fraud victims ordinarily are limited to only the out-of-pocket loss measured at the time of their investment. "In the federal courts the measure of damages recoverable by one who through fraud or misrepresentation has been induced to purchase bonds or corporate stock, is *the difference between the contract price, or the price paid, and the real or actual value at the date of the sale*, together with such outlays as are attributable to the defendant's conduct." *Estate Counseling Serv. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962) (citing precedents; emphasis added); *see* Arthur L. Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 Tex. L. Rev. 469, 471-79 (1988).

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[12] "'The means used are wrong, they are false rumors; the object is wrong, it was to give a false value to a commodity in the public market, which was injurious to those who had to purchase.'" *De Berenger*, 3 M. & S. at 76-77, 105 Eng. Rep. at 540 (Dampier, J.) (quoted in *United States v. Brown*, 5 F. Supp. 81, 86 (S.D.N.Y. 1933), *aff'd*, 79 F. 321 (2d Cir. 1935)). *See also* Berle, *supra*, 31 Colum. L. Rev. at 268-70.

[13] *See Restatement (Second) of Torts* §549 (1977); *Restatement of Torts* §549 (1938); W. Page Keeton, et al., *Prosser and Keeton on the Law of Torts* §110, at 766 (5th ed. 1984).

B. The Securities Exchange Act of 1934 Codified the Common-Law Rule that an Investor's Injury Consists of Paying a Fictitious Price

Congress codified the inflated-price rule in the 1934 Act's express remedies that "target the precise dangers that are the focus of §10(b)." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360-61 (1991). Like §10(b), they are "designed to protect investors against manipulation of securities prices." *Basic*, 485 U.S. at 230 (citing S. Rep. No. 73-792, at 1-5 (1934)); *see* 15 U.S.C. §§78i(e), 78r(a).

As this Court observed in *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 46 (1977), for example, "§9 provides an express cause of action for persons injured by unlawful market activities," and "is framed specifically in favor of 'any person who shall purchase or sell any security *at a price which was affected by such act or transaction. . . .*'" *Id.* (Court's emphasis).[14] "Congress therefore focused in §9 upon the amount actually paid by an investor for stock that had been the subject of manipulative activity."[15] The recoverable loss, then, is the "improper premium" at which the stock traded, over the price at which it would have traded absent the manipulative misconduct.[16]

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[14] Section 9 covers certain misleading statements, in addition to misleading transactions called "wash sales" and "matched orders." *See* 15 U.S.C. §78i(a)(4).

[15] 403 U.S. at 46. The 1934 Act's legislative history confirms: "In order to render effective the prohibitions against manipulation, violators are not only subject to the penalties prescribed in the act, but are liable in damages to any person who purchases or sells a security at a price which was effected [*sic*] by the violation." S. Rep. No. 73-1455, at 55 (1934).

[16] 403 U.S. at 46; *see generally* Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 Ind. L. Rev. 357, 367-68 (1991); *see also Rosenberg v. Hano*, 121 F.2d 818, 821 (3d Cir. 1941) (to recover under §9(e) an investor "must either have entered a false market or paid a false price to enter a genuine market").

When investors purchase securities at a fictitious and fraudulent price, their loss under §10(b) must be, as it is under the 1934 Act's express remedies, the "improper premium" paid. *See Piper*, 403 U.S. at 46. This Court has long held that §9 and §10(b), in particular, are fraternal twins—looking to §9 to inform its interpretation of §10(b), *see, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977), and even adopting §9(e)'s express provisions to govern implied actions under §10(b). *See, e.g., Lampf*, 501 U.S. at 364 n.9 ("we select as the governing standard for an action under §10(b) the language of §9(e) of the 1934 Act"). Congress's determination of what loss investors should recover when deceptive conduct affects the price at which securities trade is both instructive, and clear. Fraud causes loss when investors pay an inflated price.[17]

C. Section 10(b) Precedents Embrace the Traditional Rule that Loss Is Suffered at the Time of Purchase

This Court applied the fraud-inflated-price rule to §10(b) claims in *Affiliated Ute*, 406 U.S. at 155, after lower courts had widely adopted it for the Rule 10b-5 cause of action. *See* 9 Louis Loss & Joel Seligman, *Securities Regulation* 4412-4415 & nn.484, 485 (3d ed. 2004); *see also, e.g., Estate Counseling*, 303 F.2d at 533; *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965).

In *Affiliated Ute*, a bank's transfer agents violated Rule 10b-5 by purchasing securities from mixed-blood Indians

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[17] Congress also provided in 1934 Act §18(a) that those who cause misleading statements to be filed with the SEC are liable to all "who, in reliance upon such statement, shall have purchased or sold a security *at a price which was affected by such statement*, for damages caused by such reliance." 15 U.S.C. §78r(a) (emphasis added). Again, the focus is on the injury suffered in paying "a price which was affected" by the misleading statement. *Id.*; *see* Kaufman, *Loss Causation*, 24 Ind. L. Rev. at 368-69.

without disclosing the rather material fact that the securities could be sold for substantially more on an active non-Indian market. In §10(b) cases involving primarily a breached duty to disclose, this Court held, *materiality* of the omitted information establishes the "requisite element of causation in fact," permitting the plaintiffs to recover "the difference" between the transaction price and what the securities otherwise were worth. 406 U.S. at 154-55 ("the difference between the fair value of all the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct"). The recoverable loss was both suffered—and measured—at the time of the transaction.[18]

Nothing in *Affiliated Ute* suggests that to prove causation under §10(b), plaintiffs must establish that the defendant's conduct also caused a *post-transaction* change in the price of the security. Rather, when investors show how a defendant's fraudulent conduct created a disparity between the transaction price and the securities' value measured *at the time of the transaction*, they establish that the defendant's conduct caused their losses. *Affiliated Ute*, 406 U.S. at 155. As this Court later explained:

> In *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972), which involved violations of §10(b) and Rule 10b-5 by a buyer of securities, this Court held in a §10(b) action that "the correct measure of damages under §28 . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct."

[18] *Id.*; *see* Michael J. Kaufman, *Securities Litigation: Damages* §11-18 to §11-19 (2003); Kaufman, *Loss Causation*, 24 Ind. L. Rev. at 387.

Randall, 478 U.S. at 661-62; *see id.* at 662 ("Courts have also generally applied this 'out-of-pocket' measure of damages in §10(b) cases involving fraud by a seller of securities.").[19]

Following *Affiliated Ute*, the Ninth Circuit held in *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), that

> causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation of the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a *prima facie* case.

Blackie, 524 F.2d at 906.

Liability is predicated "on a showing of economic damage (loss causation)," suffered upon purchase, with investors' individual "transactional causation" or reliance inferred secondarily from the fact that reasonable investors would not choose to incur the loss.[20] Thus, the necessary "causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of

[19] This rule deals with market value, of course, not the medieval scholastics' concept of inherent value. *See* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 Cornell L. Rev. 907, 919-20 (1989); William J. Carney, *The Limits of the Fraud on the Market Doctrine*, 44 Bus. Law. 1259, 1271-73 & n.69 (1989).

[20] *Id.* at 906. Ninth Circuit decisions consistently hold that "in an action brought under Rule 10b-5 for material omissions or misstatements, the plaintiff must prove both transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused harm." *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984).

artificially inflated stock." *Blackie*, 524 F.2d at 908. Defendants, of course, retain the right to disprove causation within the traditional framework limiting recovery to those who "are in fact injured." *Id.* at 906-07 n.22.

In *Blackie*, defendants asserted (as do Dura's *amici*) that the loss must be determined by the change in price after a corrective release. *See Blackie*, 524 F.2d at 909 n.25. The Ninth Circuit held that such a "drop is of course circumstantial evidence of the inflation when purchased, but is not the exclusive method of measuring inflation." *Id.* Other market variables, including the passage of time, or changed conditions and partial disclosures, may affect later market reaction—necessitating expert testimony and the examination of company-specific information to determine the actual inflation on the date of purchase. *See id.* at 906-09 nn.22, 25.

In 1976, in *Green v. Occidental Petroleum Corp.*, Judge Sneed authored a lengthy and influential concurrence explaining the out-of-pocket rule and its application. He noted that under *Blackie*, the traditional "out-of-pocket measure" fixes recovery in investment-fraud cases at the difference between the purchase price and the value of the investment on the date of purchase—rather than at some later date. 541 F.2d. at 1344. "This difference is proximately caused by the misrepresentations of the defendant. It measures precisely the extent to which the purchaser has been required to invest a greater amount than otherwise would have been necessary." *Id*; *see also Knapp*, 90 F.3d at 1438 (Wallace, J., for the court).

Other circuit courts have long applied this "out-of-pocket" rule of loss-causation to claims under Rule 10b-5. They hold that "the issue is the amount by which each class member was defrauded on the date of his purchase. Any subsequent decline in market value had no effect on that fraudulent sale." *Sirota v. Solitron Dev. Inc.*, 673 F.2d 566, 577-78 (2d Cir. 1982) (rejecting a defendant's contentions that the plaintiff

investor's recoverable loss must be reduced in light of the drastic market decline of 1970).[21] Judge Posner has explained that the term "loss causation" generally refers, then, to the "loss produced by a discrepancy between the actual market value of a stock and what that value would have been had there been no misrepresentation." *Isquith v. Caremark Int'l*, 136 F.3d 531, 535 (7th Cir. 1998) (Posner, J., for the court).

Dura and its *amici* suggest that this rule makes those who perpetrate frauds "insurers" against unrelated market declines following any investment decisions induced by fraud. But the traditional rule's purpose and effect are precisely the opposite. The traditional view of proximate cause—seeing loss as the difference between price and value at the time of the investment rather than as a subsequent, likely much larger, decline in value of the security—Judge Sneed explained in *Green*, "furthers the purpose of rule 10b-5 without subjecting the wrongdoer to damages" for unforeseeable "natural disasters" or for general market declines unrelated to the fraud. *Green*, 541 F.2d at 1344. The defendant never becomes an

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[21] *Accord, e.g., Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 214 (7th Cir. 1993) (Easterbrook, J.); *Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp.*, 910 F.2d 1540, 1551 (7th Cir. 1990) (rejecting benefit-of-the-bargain for out-of-pocket loss; citing *Sigafus*); *Mayer v. Mylod*, 988 F.2d 635, 640 (6th Cir. 1993) ("Under Section 10(b), the level of damages is usually the difference in price that the investor paid based on false or misleading statements and the price that the stock would have sold at had the market been aware of the truth."); *Hoxworth v. Blinder, Robinson & Co.*, 903 F.2d 186, 203 n.25 (3d Cir. 1990) ("Ordinarily, a defrauded buyer is entitled to out-of-pocket damages under rule 10b-5."); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1136-37 (5th Cir. 1988), *vacated on other grounds*, 492 U.S. 914 (1989); *Flamm v. Eberstadt*, 814 F.2d 1169, 1179-80 (7th Cir. 1987) (Easterbrook, J.); *Harris v. Union Elec. Co.*, 787 F.2d 355, 367-68 (8th Cir. 1986); *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1360 (8th Cir. 1977) (out-of-pocket rule "provides for the recovery of the difference between the actual value of the securities and their purchase price").

"insurer" against general market risks precisely because, in the typical case, it is liable only for the initial inflation caused by a material misrepresentation or omission—no more, but no less.

And while Dura and its *amici* contend the traditional rule creates a risk of "windfall" or "double" recoveries for investors who sell the stock at a similarly inflated price, that has never been true: "If the stock is resold at an inflated price, the purchaser-seller's damages . . . must be diminished by the inflation he recovers from his purchaser." *Blackie*, 524 F.2d at 908-09; *accord*, *e.g.*, *Green*, 541 F.2d at 1344-46 (Sneed, J., concurring); *Wool*, 818 F.2d at 1437-38 & n.4. "For purchasers who sell *after* a disclosure which completely corrected the misrepresentations of the defendant, damages are determined only at the *time of purchase*." *Wool*, 818 F.2d at 1437 n.4 (court's emphasis). "For in-and-out traders, on the other hand, both the *time of purchase* and the *time of sale* are considered in determining recoverable damages." *Id.* (court's emphasis). The Ninth Circuit explained in *Wool*:

> Instead of determining the damages at the date of purchase, therefore, a two-step process is used when dealing with in-and-out traders. First, the spread between market price and value of the stock at the time of purchase is determined. When the purchaser sells the stock, the spread is again measured.

Id. "If the spread has diminished" the purchaser would recover the difference. *Id.* But not otherwise. In practice, as well as theory, courts disallow the double-recoveries and windfalls that Dura and its *amici* purport to fear. *See*, *e.g.*, *In re Cendant Corp. Sec. Litig.*, 109 F. Supp. 2d 235, 254 (D.N.J. 2000), *aff'd*, 264 F.3d 201 (3d Cir. 2001); *In re LTV Sec. Litig.*, 88 F.R.D. 134, 148-49 (N.D. Tex. 1980).

While Dura suggests that the Fifth Circuit in *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983), came to a radically different conclusion on recoverable losses in §10(b) cases, that is not so. In *Huddleston*, the Fifth Circuit said that when investors point to a stock's decline in value, claiming it as their loss, "[t]he causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value." *Id.* There is no reason to think that with these words the Fifth Circuit meant to abandon the traditional rule—reaffirmed later in the same opinion—that the investors were entitled to recover "the difference between the price paid and the 'real' value of the security, *i.e.*, the fair market value absent the misrepresentations, at the time of the initial purchase." *Id.* at 554-55. This difference the Fifth Circuit recognized as "the loss proximately caused by the defendants' deceit." *Id.* at 555.[22]

This Court again embraced the traditional rule, and existing law on causation, in *Basic*. "'In an open and developed market, the dissemination of material misrepresentations or withholding of material information typically affects the price of the stock . . . .'" 485 U.S. at 244 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986)). Under such circumstances, this Court agreed with *Blackie*, the required "'causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the

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[22] A footnote's illustrative hypothetical earlier in the opinion is perhaps at odds with *Huddleston's* ultimate holding. The hypothetical suggests that misrepresentations about a ship's capacity may not lead to recovery if the ship sinks for reasons unrelated to capacity. Investors' damages, however, "consist of two components: the value lost due to the casualty and the amount lost because [the investor] overpaid for the stock. This latter component of damages is related directly to the initial misrepresentation. Hence, this amount should be recoverable in an action for securities fraud." *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 650 F. Supp. 1346, 1353-54 (W.D. Wash. 1986), *aff'd*, 823 F.2d 1349 (9th Cir. 1987) ("*WPPSS*").

form of artificially inflated stock.'" *Basic*, 485 U.S. at 244-45 (quoting *Blackie*, 524 F.2d at 908).[23]

Discussing how reliance and causation may be rebutted this Court focused, again, not on the post-transaction movements in the value of the security, but on the causal "link between the alleged misrepresentation and either the price received (or paid) by the plaintiff." *Basic*, 485 U.S. at 248. Defendants thus are entitled to "show that the misrepresentation in fact did not lead to a distortion of price." *Id.* If, for example, they "could show that the 'market makers' were privy to the truth . . . and thus that the market price would not have been affected by their misrepresentations, the causal connection could be broken." *Id.* What the price does *after* the loss was suffered never comes into the equation—except as one piece of *evidence* of the amount of inflation. *See Blackie*, 524 F.2d at 909 n.25.

Until the PSLRA's enactment in 1995, the case law remained quite consistent. After *Basic*, the Third Circuit in *Scattergood v. Perelman*, 945 F.2d 618, 624 (3d Cir. 1991), reversed dismissal on the pleadings because "the fair inference from the complaint, if one assumes—as we must—the truth of its allegations, is that the market price paid by the plaintiffs exceeded the value of the stock at the time of the purchase based on the true facts. In other words, the complaint suggests that the price paid exceeded the value that the market would have established for the Andrews stock had the defendants disclosed their scheme . . . ."

[23] *Cf.* Fischel, *supra*, *Use of Modern Finance Theory*, 38 Bus. Law. at 11 ("Investors would not be willing or have to pay the increment attributable to distortion of the price if the true information were known.").

And in *Pommer v. Medtest Corp.*, 961 F.2d 620, 628 (7th Cir. 1992), Judge Easterbrook contrasted §10(b) with the 1933 Act's provision for rescissory damages, explaining that:

> Damages under §10(b), by contrast, usually are the difference between the price of the stock and its value on the date of the transaction if the full truth were known. Sometimes this principle comes under the name "loss causation": the plaintiff must establish that the misstatement caused him to incur the loss of which he complains; it is not enough to establish that the misrepresentation caused him to buy or sell the securities.

Id. (citation omitted).

Thus, when Congress codified loss causation in 1995, the causation that counted in Rule 10b-5 cases involving open-market purchasers of securities was the nexus between the defendant's conduct and the transaction price. When plaintiffs pleaded that misleading statements and omissions created a difference between that transaction price and the true value of the securities at the time of the transaction, they thereby established, at least at the pleading stage, that the defendant's conduct caused their recoverable losses. The legislation's Senate Report, for example, says that Congress intended to codify "current law" on the point. S. Rep. No. 104-98, at 7; *see infra*.

II. THE PSLRA ADOPTED THE TRADITIONAL FRAUD-INFLATED-PRICE RULE OF LOSS CAUSATION FROM PRE-PSLRA SUPREME COURT AND CIRCUIT COURT DECISIONS

It was in this context that Congress codified "loss causation" as an element of §10(b) liability, in Securities Exchange Act §21D(b)(4). Congress determined that if investors survived the PSLRA's heightened pleading standards on a motion to dismiss, *see* 15 U.S.C. §78u-4(b)(1)-(3), they then "shall have the burden of proving that the act or omission of

the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. §78u-4(b)(4). The statute's plain language imposes pleading requirements for misleading statements and scienter, but it says nothing at all about pleading loss—only that the plaintiff eventually must prove loss. Even then, its text says nothing about linking a specific corrective disclosure to a stock drop. The legislative record, in fact, confirms that in fraud-on-the-market cases the new provision's standard is met with evidence establishing fraudulent inflation of a security's price at the time the plaintiff bought it.

Although Dura says that in 1994 members of the 103d Congress had "expressed concern that some courts were adopting a presumption of loss causation, as well as reliance, in fraud-on-the-market cases" (Petitioners' Brief at 29 n.9), the supporting document—a subcommittee staff report—states only that because other factors may neutralize a misrepresentation's effects, "it may therefore be appropriate to require plaintiffs to provide proof in fraud-on-the-market cases that the alleged misrepresentation caused an effect on market price."[24]

Moving on to the 104th Congress, the House bill to reform securities litigation would have required a plaintiff to prove "that the misstatement or omission proximately caused (through both transaction causation and loss causation) any

[24] The staff report explained: "There may be cases in which the plaintiff reasonably relied on the integrity of the market price, but the market price was not affected by the defendants' misrepresentations because other information in the market neutralized any impact which the misrepresentation might have had." Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, Staff Report on Private Securities Litigation 58 (May 17, 1994), *reprinted in Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the Subcommittee on Securities*, 103d Cong., 228 (May 12, 1994).

loss incurred by the plaintiff." H.R. 10, 104th Cong., §204 (Jan. 4, 1995).[25] The Senate bill, on the other hand, provided that in fraud-on-the-market cases "the plaintiff shall have the burden of proving that the misstatement or omission caused any loss incurred by the plaintiff." S. 240, 104th Cong., §104 (Jan. 18, 1995).[26]

Its authors' section-by-section analysis explained that the provision "clarifies that in implied actions based on the 'fraud in the market' theory, while the plaintiff need not show that he or she specifically relied on any alleged misstatement or omission, plaintiff has the burden of showing that the misstatement or omission caused the loss." 141 Cong. Rec. S1086-87 (Jan. 18, 1995). "This means that plaintiff must establish that it was the defendant's misstatement or omission, rather than some intervening factor, which established the market price at which the plaintiff purchased or sold the securities in question." *Id.* Plaintiffs, in fraud-on-the-market cases, would have to show that the fraud alleged affected the price that they paid. *See id.*[27]

[25] With H.R. 10, Congress initially considered dramatically narrowing the fraud-on-the-market doctrine as articulated in *Basic*, but ultimately left the *Basic* decision intact, thereby retaining a strong fraud-on-the-market doctrine as set forth by this Court. *See* H.R. Rep. No. 104-50, at 65-66 (Feb. 24, 1995).

[26] The Senate bill's loss-causation provision read in full:

> (c) BURDEN OF PROOF—In an implied private action under this title based on a material misstatement or omission concerning a security, and in which the plaintiff claims to have bought or sold the security based on a reasonable belief that the market value of the security reflected all publicly available information, *the plaintiff shall have the burden of proving that the misstatement or omission caused any loss incurred by the plaintiff.*

S. 240, 104th Cong., §104 (Jan. 18, 1995) (emphasis added).

[27] Such an explanation, from the drafters themselves, is highly significant. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-03 (1976)

The SEC, in a letter from Chairman Arthur Levitt to Senator Richard Bryan, concurred that "S. 240 would make it clear that the plaintiff is required to prove that the misstatement or omission caused his loss; *i.e.*, that the price at which the plaintiff purchased his shares was artificially inflated as a result of the misstatement or omission."[28] All agreed that loss consisted of paying an inflated price.

The Banking Committee amended the Senate bill by simplifying and broadening its text to apply to all private claims under the 1934 Act, and by adding a second sentence (later dropped in Conference). As reported by the Committee, it provided:

> In any private action arising under this title, the plaintiff shall have the burden of proving that the act or omission alleged to violate this title caused any loss incurred by the plaintiff. Damages arising from such loss may be mitigated upon a showing by the defendant that factors unrelated to such act or omission contributed to the loss.

S. 240, 104th Cong., §104(b) (June 19, 1995). The second sentence restated what the Ninth Circuit held in *Blackie* and this Court in *Basic*—that defendants are entitled to rebut a plaintiff's *prima facie* case by showing there was no inflation. *See Basic*, 485 U.S. at 248-49; *Blackie*, 524 F.2d at 906 & n.22; *see, e.g.*, *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1114-16 (9th Cir. 1989).

The Senate Report characterized the provision as one "codifying the requirement under current law that plaintiffs

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(holding that a "brief explanation of §10(b) by a spokesman for its drafters is significant"); *Philko Aviation, Inc. v. Shacket*, 462 U.S. 406, 410 (1983) (interpreting statute as "dictated by" the "House and House Conference Committee Reports, and the section-by-section analysis of one of the bill's drafters").

[28] Letter from Arthur Levitt to Senator Richard Bryan, at 8 (May 11, 1995) (described in Respondents' November 17 letter).

prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors," explaining that it

> requires the plaintiff to show that the misstatement or [omission] alleged in the complaint caused the loss incurred by the plaintiff. *For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.* The defendant would then have the opportunity to prove any mitigating circumstances, or that factors unrelated to the fraud contributed to the loss.

S. Rep. No. 104-98, at 7, 15 (emphasis added). Once again, the relevant loss clearly consisted of paying an artificially inflated price, with the legislation requiring eventual proof merely "that the price at which the plaintiff bought the stock was artificially inflated." *Id.*

In the end, the Conference Committee dropped the second sentence and enacted: "In any private action arising under this title, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. §78u-4(b)(4). The only suggestion that §21D(b)(4) might require plaintiffs to *plead* anything about loss causation came not from the new statute's text, but from the accompanying Statement of the Managers which confirmed, once more, that loss is suffered by paying an artificially inflated price:

> *Loss causation*
>
> The Conference Committee also requires the plaintiff *to plead and then to prove* that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff in new Section 21D(b)(4) of the 1934 Act. *For example, the plaintiff would have to prove that the price at which the plaintiff bought the*

> *stock was artificially inflated as the result of the misstatement or omission.*

H.R. Conf. Rep. No. 104-369, at 41 (emphasis added).

This, of course, is what the Ninth Circuit holds—that "plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." *Knapp*, 90 F.3d at 1438 (Wallace, J., for the court); *see* PA9a (quoting *Knapp*). This is the very rule applied in *Basic*, which held that "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury," which may be "'established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock.'" *Basic*, 485 U.S. at 243-45 (quoting *Blackie*, 524 F.2d at 908). Thus, the 1995 legislation codifies the older rule and Ninth Circuit law, rather than the newer "rule" that Dura and its *amici* try to derive from subsequent decisions.

A. Section 21D(b)(4), Which Speaks of "Proof," Not Pleading, Cannot Be Reasonably Construed as Imposing a Heightened Particularity Requirement for Pleading Loss Causation

Dura and its *amici* contend that it is not enough for investors to plead and prove that misrepresentations and omissions, made with scienter, caused them to pay a fraudulent price. The United States says that §21D(b)(4) requires complaints both to plead loss causation with "particularity" and to provide specifics as to how inflation was "taken out" of a security's price before suit was filed. U.S. Brief at 15.[29]

[29] The United States suggests that Federal Rule of Civil Procedure 9(b) requires this too, but Rule 9(b) requires only that "the circumstances constituting fraud or mistake shall be stated with particularity." With the PSLRA, it requires scienter to be alleged with particularity. 15 U.S.C. §78u-4(b)(2). Although *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 510-13 (2002), acknowledged that under Rule 9(b) averments of "the circumstances constituting fraud" must be "stated with particularity" (*id.* at 513 n.3), there is no requirement that the elements of liability apart from the "circumstances constituting fraud"—*i.e.*, falsity and fraudulent conduct—need be pleaded with particularity.

Dura thinks that §21D(b)(4) requires much more—a bright-line rule that investors identify specific corrective disclosures (of the truth) corresponding to specific stock price drops (the loss, in their view). Dura's *amici* insist that §21D(b)(4) thus requires the complaint to include expert testimony supported by "[a]n event study . . . 'a statistical regression analysis that examines the effect of an event, such as an allegedly fraudulent statement or omission, on a dependent variable, such as a company's stock price.'"[30]

Such notions find no support at all in §21D(b)'s statutory text which, on its face, imposes particularized pleading requirements for falsity and scienter allegations, but imposes no burden of *pleading* loss causation. *See* 15 U.S.C. §78u-4(b)(1), (2); *Gebhardt v. ConAgra Foods*, 335 F.3d 824, 830 n.3 (8th Cir. 2003).

While §21D(b) specifies certain "Requirements for Securities Fraud Actions," only subsections (1) and (2) purport to impose special pleading standards. First,

> *the complaint shall specify* each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, *the complaint shall state* with particularity all facts on which that belief is formed.

[30] Securities Industry Ass'n Brief at 9-10 & n.6 (quoting *In re World Access, Inc. Sec. Litig.*, 310 F. Supp. 2d 1281, 1298 n.10 (N.D. Ga. 2004) (granting motion for summary judgment)). The cases cited for this proposition deal with summary judgment or settlement—not pleading standards—and one of them actually *rejects* the S.I.A.'s position that plaintiffs must show a decline in price on disclosure: *In re Executive Telecard Sec. Litig.*, 979 F. Supp. 1021, 1028-29 (S.D.N.Y. 1997).

15 U.S.C. §78u-4(b)(1) (emphasis added). Thus, investors must plead in detail facts explaining why a statement was materially misleading—a significant burden in light of this Court's holdings that plaintiffs must demonstrate "'a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" *Basic*, 485 U.S. at 231 (quoting *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Second, with respect to fraudulent intent, Congress again specified that

> the *complaint shall*, with respect to each act or omission alleged to violate this title, *state with particularity* facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. §78u-4(b)(2) (emphasis added).

"This is not an easy standard to comply with—it was not intended to be—and plaintiffs must be held to it." *Eminence Capital, L.L.C. v. Aspeon, Inc.*, 316 F.3d 1048, 1052 (9th Cir. 2003). Following the pleading requirements of subsections (b)(1) and (b)(2), indeed, is subsection (b)(3)'s command that "the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met." 15 U.S.C. §78u-4(b)(3). No one can accuse the Ninth Circuit of failing to honor this command. *See, e.g., DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir. 2002); *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999).

When the complaint *survives* such a motion, however, subsection (4) specifies that the plaintiff then "shall have *the burden of proving* that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. §78u-4(b)(4) (emphasis added). Congress did not detail how this proof must ultimately be presented, let alone command it must be adduced *at the pleading stage*. Subsection (b)(4) simply

"does not deal with pleading." *EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 883 (3d Cir. 2000); *see Gebhardt*, 335 F.3d at 830 n.3; *In re Elec. Data Sys. Corp. Sec. Litig.*, 298 F. Supp. 2d 544, 560 (E.D. Tex. 2004). If anything, the statute's text rather clearly indicates that loss causation is something to be dealt with only *after* a plaintiff has met the PSLRA's strict pleading requirements, set forth in subsections (1) and (2).

For the burden of *pleading* and the burden of *proving* are two different things, and the statute's drafters specified quite clearly what must be pleaded. Unlike §21D(b)'s first two subparagraphs, the one requiring plaintiffs *to prove* loss causation says nothing about what *the complaint* must *plead*—only that plaintiffs who have met the preceding pleading requirements must eventually *prove* loss causation. "'Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.'" *Gozlon-Peretz v. United States*, 498 U.S. 395, 404 (1991) (quoting *Russello v. United States*, 464 U.S. 16, 23 (1983)). Moreover, had Congress meant to increase the pleading requirements for loss causation, it surely would have said so: "*Expressio unius est exclusio alterius.*" *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993); *accord, e.g., Swierkiewicz*, 534 U.S. at 513; *TRW Inc. v. Andrews*, 534 U.S. 19, 28 (2001).

Generally speaking, "'when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.'" *Lamie v. United States Tr.*, 540 U.S. 526, 124 S. Ct. 1023, 1030 (2004) (citation omitted). And here, leaving loss causation for proof at trial makes sense. Under the PSLRA, private securities fraud plaintiffs generally are foreclosed from pursuing discovery against the defendants

until *after* their complaint has survived a motion to dismiss. 15 U.S.C. §78u-4(b)(3)(B). And yet discovery—and expert testimony—may be needed to determine the impact of accounting manipulations on reported results, and thus on stock price.

Even when fraud has been established, it may be very difficult to untangle with precision what portion of a stock's initial inflation and later decline is attributable to which misstatement and what corrective disclosure. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975) (noting that "the damages suffered by purchasers and sellers pursuing a §10(b) cause of action may on occasion be difficult to ascertain"). This Court noted in *Basic* that "there may be a certain incongruity between the assumption that Basic shares are traded on a well-developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements." 485 U.S. at 248 n.29. "Proof of that sort is a matter for trial," *id.*, inappropriate for a contest on the pleadings.[31] It presents complex issues requiring expert testimony, ill-suited to determination on the pleadings.

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[31] *See, e.g., Gebhardt*, 335 F.3d at 832 ("we decline to attach dispositive significance to the stock's price movements absent sufficient facts and expert testimony, which cannot be considered at this procedural juncture"); *Huddleston*, 640 F.2d at 553-54 (in securities cases, "amount of damages is a jury issue although the services of a special master or the testimony of an expert witness . . . may be particularly helpful"); *Blackie*, 524 F.2d at 909 n.25 ("The fact finder may rely on other methods of determining actual value on the date of purchase, including expert testimony . . . ."); *see also* Brief for the Securities and Exchange Commission as *Amicus Curiae* in *Basic Inc. v. Levinson*, No. 86-279, at 27 n.34 ("While the fraud on the market theory permits a presumption that material misstatements affected the market price, the plaintiff retains the burden of establishing, in a manner that will vary from case to case, the *amount* of his damages.").

B. The PSLRA's Amendment to Section 12 of the 1933 Act, Which Provides for Recissory Awards, Does Not Apply to Section 10(b) Actions to Recover Out-of-Pocket Losses

Dura and the United States insist the PSLRA's amendment to §12 of the Securities Act of 1933 somehow changed loss-causation rules for 1934 Act claims. Yet courts have long held that fundamentally different rules apply under the 1933 Act, which affords rescissory relief to investors who purchase new stock issues, and the 1934 Act's provisions dealing with fraud and manipulation in the after-market—where courts have always focused on the loss suffered when investors pay a manipulated price.[32]

As originally enacted in 1933, §11(e) and §12(2) both provided for rescission and restitution upon plaintiff's tender of the security, "or for damages" if the security had been sold.[33] "Even in the latter situation, we may assume that a rescissory measure of damages will be employed," with damages "'to be measured so as to result in the substantial equivalent of rescission.'" *Randall*, 478 U.S. at 655-56 (quoting L. Loss, *Fundamentals of Securities Regulation* 1020 (1983)); *see also Hoxworth*, 903 F.2d at 203 n.25. This, of course, made those who issued or sold securities pursuant to a misleading registration statement or prospectus insurers against market losses unrelated to their statutory violations: "Congress shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud." *Randall*, 478 U.S. at 659 (discussing §12 liability).

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[32] *See* Michael J. Kaufman, *Loss Causation Revisited*, 32 Sec. Reg. L. J. 357, 370-74 (publication forthcoming winter 2004) (described in Respondents' November 17 letter).

[33] Pub. L. No. 73-22, §11(e), 48 Stat. 74, 83 (1933); Pub. L. No. 73-22, §12(2), 48 Stat. 74, 84 (1933).

With the 1934 Act Congress modified §11(e), but not §12(2), retaining a rescissory measure of damages for §11 while allowing defendants to avoid some of that liability. *See* Securities Act of 1934, Pub. L. No. 73-291, §201(d), 48 Stat. 905, 907-08 (1934) (amending §11). The amendment to §11 retained a *presumption* that §11 plaintiffs are entitled to a recissory award, but added "[t]hat if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable." *Id.* at 908. This permitted the §11 defendant "to reduce the damages so that he will not be liable for damages which he proves had no relation to his misconduct." H.R. Conf. Rep. No. 73-1838, at 41 (1934).[34] Section 12 "was left untouched." *Randall*, 478 U.S. at 661.

Nothing in the statute or its legislative history suggests that the 1934 Act's amendment to §11(e), whose rescissory measure of damages focuses on the difference between price paid (not to exceed the offering price) and value at a later date, meant that a similar rule must govern 1934 Act claims. While this Court observed in 1986 in *Randall* that there is some question as to whether and under what circumstances rescission or a recissory measure of damages may be available under §10(b), it underscored that *Affiliated Ute* had "held that ordinarily 'the correct measure of damages'" for §10(b)

[34] *See* John Hanna, *The Securities Exchange Act of 1934*, 23 Cal. L. Rev. 1, 7-8 (1934). The measure of damages under §11(e) thus allows plaintiffs to recover the post-transaction decline in value of their investments, placing upon defendants the risk of such post-transaction price declines. *See IPO*, 241 F. Supp. 2d at 349-50; *Akerman v. Onyx Communs., Inc.*, 609 F. Supp. 363, 368-69 (S.D.N.Y. 1984), *aff'd in part*, 810 F.2d 336 (2d Cir. 1987).

claims is the "out-of-pocket" loss. *Randall*, 478 U.S. at 661-62 (quoting *Affiliated Ute*, 406 U.S. at 155). Out-of-pocket loss, not a rescissory measure, remained the usual rule for 1934 Act claims. *See supra* §I.C.

Six decades after it amended §11, Congress decided in 1995 to make a similar modification to §12. The Senate Report explains that the 1995 "amendment to Section 12(2) is modeled after Section 11 of the Securities Act, which provides for a similar affirmative defense." S. Rep. No. 104-98, at 23. Did adding §11(e)'s affirmative defense to §12(2) mean that Congress intended thereby to radically revise §10(b) loss-causation principles? Of course not.

In the intervening half century courts and commentators had drawn a sharp distinction between the rescissory remedies provided by 1933 Act sections 11 and 12, on the one hand, and the 1934 Act's out-of-pocket remedies, on the other—holding that rescissory awards are the exception under the 1934 Act, and that the loss proximately caused by after-market manipulation and fraud ordinarily is the difference between price and value on the date of the transaction itself.[35] Had Congress meant to change the rule for 1934 Act claims, it would have said so. It did not.

The rule under §11(e) since 1934, and under §12(a)(2) since 1995, is essentially "a modification of rescission," while 1934 Act claimants typically are limited to the difference between "purchase price and the 'value' of the stock on the day of the purchase." Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 329-30,

[35] *See, e.g.*, *Pommer*, 961 F.2d at 628 (Easterbrook, J., for the court); *Hoxworth*, 903 F.2d at 203 n.25; *Huddleston*, 640 F.2d at 555; *Green*, 541 F.2d at 1341-43 (Sneed, J. concurring); *Elkind v. Liggett & Myers*, 635 F.2d 156, 169 n.25 (2d Cir. 1980); *WPPSS*, 650 F. Supp. at 1355-56; *Akerman*, 609 F. Supp. at 369. *See also* Kaufman, *Loss Causation Revisted*, 32 Sec. Reg. L.J. at 370-74.

335 (Harvard Univ. Press 1991); *see Green*, 541 F.2d at 1341-46. And it is surprising, to say the least, that Dura and its *amici* would contend that 1934 Act claims now are governed by 1933 Act principles. The 1933 Act's rescissory damages rules were designed to have an "in terrorem effect." *Globus v. Law Research Servs., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969). "The doctrines that apply to fraud in the issuance of securities can produce quite spectacular recoveries," Judge Easterbrook and Professor Fischel have observed, precisely because investors are not limited to out-of-pocket loss at the time of purchase—permitting recovery of far larger post-purchase declines. Easterbrook & Fischel, *supra*, at 335-36.

C. The PSLRA's "Look-Back" Damages Cap Supports the Ninth Circuit's Inflated-Purchase Price-Standard

Section 21D(e)(1) places a "look-back" cap on damages an investor might otherwise be entitled to recover under the 1934 Act, by providing that if

> the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

15 U.S.C. §78u-4(e)(1). Making the "purchase or sale price paid or received" the reference point for the harm suffered shows that this is when Congress sought to fix loss. *See id.* Congress was concerned that "[b]etween the time a misrepresentation is made [and plaintiff purchases] and the time the market receives corrected information, however, the price of the security may rise or fall for reasons unrelated to the alleged fraud." H.R. Conf. Rep. No. 104-369, at 42. Because

damages, *i.e.*, the initial overpayment, may be only a fraction of a stock's subsequent market decline, Congress worried that "[c]alculating damages based on the date corrective information is disclosed may end up substantially overestimating plaintiff's damages."[36] That, of course, was Judge Sneed's concern in *Green*, too.

Dura claims the traditional focus on price inflation at the time of purchase produces "impracticality," because hypothetical plaintiffs might satisfactorily plead loss causation yet recover no damages if the stock price either does not decline, or rebounds within the 90-day "look-back" period to above what they paid. Yet *the very purpose* of the damages cap is to bar relief that plaintiffs might otherwise be able to pursue—and recover—when all the elements of liability have been met. As the Fourth Circuit recently held in *Miller v. Asensio & Co.*, 364 F.3d 223 (4th Cir. 2004), the "*fact* of proximately caused damage and the *amount* of proximately caused damage" involve "separate, although related, inquiries," and the PSLRA itself "suggest[s] a distinction between 'the loss' and the amount for which damages can be recovered by stating that in a Rule 10b-5 action, the plaintiff must prove the defendant's actions caused '*the loss* for which the plaintiff seeks *to recover damages*.'" *Id.* at 230 (court's emphasis) Proximate cause requires "only that the plaintiff show the defendant's conduct was a *substantial* cause of its injury; it is during the subsequent damages inquiry that the exact amount of damages *solely* caused by the defendant's conduct must be calculated." *Id.* at 232 (court's emphasis).

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[36] *Id.* "According to an analysis provided to the Senate Securities Subcommittee, on average, damages in securities litigation comprise approximately 27.7% of market loss." *Id.* The analysis was based on calculating loss and then damages at the time of purchase based on the inflation in the stock as a result of fraud, and eliminating losses caused by other market factors unrelated to the fraud. *Id.*

In addition, §21D(e)(1) says its limitations apply only *when* plaintiffs seek "to establish damages by reference to the market price of a security." 15 U.S.C. §78u-4(e)(1). Congress, and the United States as *amicus* in this case (*see* U.S. Brief at 19-21), thus realize there are *other* ways to establish damages than by pointing to a price drop. If a decline in price on disclosure of the truth is one way of demonstrating inflation and damages, it is not the only way. In *Blackie*, 524 F.2d at 906, cited by this Court in *Basic*, the Ninth Circuit explained the plaintiffs' loss suffered at the time of purchase need not always be connected to a subsequent decline in the security's price:

> [Defendants] contend that the inflation paid must be measured by the change in price after a corrective release. That drop is of course circumstantial evidence of the inflation when purchased, but it is not the exclusive method of measuring inflation. *The fact finder may rely on other methods of determining actual value on the date of purchase, including expert testimony on actual value* . . . . In any event, the drop after a corrective disclosure will not be conclusive of the amount of original inflation . . . .

Id. at 909 n.25 (emphasis added); *accord Knapp*, 90 F.3d at 1437-38 (Wallace J., for the court); *Wool*, 818 F.2d at 1437 & n.3; *Green*, 541 F.2d at 1341-46 (Sneed, J., concurring).

Another reason for the look-back cap was Congressional fear that upon an adverse disclosure a stock may initially overreact.[37] And again, if the drop was to be used as evidence of the inflation per *Blackie*, allowing time for the market to absorb the news—and discount any over-reaction—was thought to provide some further protection to companies, "limit[ing] damages to those losses caused by the fraud and not by other market conditions." S. Rep. No. 104-98, at 28. Congress, as was its prerogative, extended the rebound time to include a full three-month reporting cycle. This was again a policy determination not based on an efficient market or causation.

Here, the 90-day look-back means, at most, that investors who purchased shortly before Dura's November 1998 announcement would have no damages. But those who purchased at higher prices do.[38] Thus, the look-back's cap does not define the relevant loss as one suffered on disclosure.

III. THE DECISIONS HERALDED BY DURA AND ITS *AMICI* AS THE "MAJORITY" RULE ARE ACTUALLY THE FIRST CASES TO DEVIATE FROM THE TRADITIONAL RULE AND THE PSLRA

Far from representing a "majority" rule, as Dura's *amici* would have it, the first case that appears actually to *reject* the traditional rule that loss causation is established by paying an inflated price is *Robbins*, which held in 1997 that "[p]roof of damages under the out-of-pocket rule is not proof of loss causation." 116 F.3d at 1447. Congress could not possibly have intended to codify an opinion issued two years after the PSLRA's passage. *Robbins* noted that "[s]ome courts have held that 'in a fraud-on-the market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.'"

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[37] In determining the look-back provision was necessary to prevent over-compensation to plaintiffs, Congress considered the "crash component" associated with the disclosure of fraud, *i.e* , the over-reaction of the market to such news. H.R. Conf. Rep. No. 104-369, at 42. Congress relied on an article that discusses a rebound period of days to weeks, allowing time for the market to absorb the full meaning of the news released and rebound. *Id.*; *see* Baruch Lev and Meiring deVilliers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 Stanford L. Rev. 7, 9-11 (1994).

[38] *See* stock chart tracking the 90-day look-back mean trading price in this case, in the addendum to this brief.

Robbins, 116 F.3d at 1438. Those, of course, are the earlier precedents to which Congress actually looked. *See supra*.

"But the fraud on the market theory, as articulated by the Supreme Court," the Eleventh Circuit continued in *Robbins*, "is used to support a rebuttable presumption of reliance, not a presumption of causation." *Robbins*, 116 F.3d at 1438 (citing *Basic*, 485 U.S. at 241-42). This, of course, ignores what this Court said in *Basic*. It upheld a fraud-on-the-market claim because "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury," and there is "more than one way to demonstrate the causal connection." *Basic*, 485 U.S. at 243. In a fraud-on-the-market case, this Court held, the "'causal nexus can be adequately established indirectly, by proof of materiality, coupled with the common sense that a stock purchaser does not seek to purchase a loss in the form of artificially inflated stock.'" *Basic*, 485 U.S. at 244-45 (quoting *Blackie*, 524 F.2d at 908). The Court's discussion of how defendants might *rebut* the inference of reliance and causation demonstrates that its focus was on stock price at the time of the investor's purchase or sale. *Id.* at 248-49. And the *concepts* of loss causation and transaction causation remain distinct though closely related—since transaction causation is inferred from investors' unwillingness to sustain a loss proximately caused by purchasing inflated stock. *See id.* at 244-45 (quoting *Blackie*, 524 F.2d at 908).

Neither dictum in *Emergent*, 343 F.3d 189, nor decisions requiring investors who cite a decline in price as their loss to connect it to fraud, can justify overthrowing this approach.

Dura's reliance on *Bastian*, 892 F.2d at 683-86, is particularly misplaced. There, plaintiffs said they invested $600,000 in a limited partnership in direct reliance on defendants' false claim of business competence. *Id.* at 682. Within three years the partnership was worthless, apparently due to declining *industry* profits. *Id.* at 684. Plaintiffs never

alleged, despite amendment, that defendants' misrepresentations distorted the acquisition price of the securities. *See* Kaufman, *Loss Causation Revisited*, 32 Sec. Reg. L.J. at 367. Plaintiffs claimed it was sufficient that they invested in reliance on defendants' misstatements and that the business later failed, insisting that they had to do nothing more to show a loss caused by fraud. 892 F.2d at 683. Not surprisingly, the court rejected plaintiffs' contention, holding that a business failure for reasons unrelated to the alleged fraud is not a loss proximately caused by that fraud. *Id.* at 684. Judge Posner explained that investors cannot recover a post-purchase decline in market value caused by forces unrelated to fraud. *Id.* at 685.[39]

The Seventh Circuit subsequently clarified that its requirement for proving loss causation in a Rule 10b-5 case "ought not place unrealistic burdens on the plaintiff at the initial pleading stage." *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997). The plaintiff must allege that defendant "made a fraudulent misstatement and that this misstatement was responsible for its damage." *Id.* In Rule 10b-5 cases, moreover, "damages are usually the difference between price of the stock and its value on the date of the

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[39] Judge Posner's Broker-Customer hypothetical confirms he was not rejecting recovery for fraud-based inflation:

> Suppose a broker gives false assurances to his customer that an investment is risk-free. In fact it is risky, the risk materializes, the investment is lost. Here there can be no presumption that but for the misrepresentation the customer would have made an equally risky investment. On the contrary, the fact that the broker assured the customer that the investment was free of risk suggests that the customer was looking for a safe investment. Liability in such a case (well illustrated by *Bruschi v. Brown*, *supra*, 876 F.2d at 1527) is therefore consistent with non-liability in a case such as the present.

Bastian, 892 F.2d at 685-86.

transaction if the full truth had been known." *Id.* at 649 n.6.[40] This, of course, is what the Ninth Circuit holds—that "plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation." *Knapp*, 90 F.3d at 1438 (Wallace, J., for the court); *see* PA9a (quoting same).

Dura and its *amici* cite *Prosser and Keeton*, and the *Restatement (Second) of Torts*, for the principle that "if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors in no way relate[d] to the representations will not afford any basis for recovery."[41] But this is exactly what the Ninth Circuit holds by focusing on out-of-pocket loss at the time of purchase—to the exclusion of unrelated later declines in value. "Where, as is commonly the case," *Prosser* explains, "the defendant's actionable misrepresentation or non-disclosure induces a transaction that involves the transfer of something of value, courts normally resort to a general measure of damages often referred to as direct damages, and, in addition thereto, will allow such other damages as special or consequential damages as the plaintiff can prove." *Prosser & Keeton*, *supra*, §110, at 766. If an investor seeks to recover as "loss" the difference between what he transferred and what he would have transferred

[40] In light of *Caremark*, suppose that in *Bastian* the plaintiffs had proved that defendants' misstatements *had* distorted the share price of the partnership causing an overpayment of $25 a share, *i.e.*, from $25 to $50; and plaintiffs had invested $1,200,000 instead of $600,000. Shortly thereafter, the entire industry collapsed and the stock became worthless. Applying Judge Posner's analysis, $25 of the plaintiffs' $50 loss per share ($600,000), is attributable to the industry collapse and cannot be recovered through suit. The other $25 per share should be recoverable because defendants' fraud caused plaintiff to pay too much (inflated price).

[41] *Prosser and Keeton*, *supra*, §110, at 767. The *Restatement* contains a similar example. *Restatement (Second) of Torts* §548A cmt. b.

absent the fraud, that loss is recoverable. Only if the plaintiff seeks *in addition* to recover consequential or special damages, must a subsequent decline in stock value be caused by the fraud. And again, in §10(b) cases such additional damages have generally been denied.

IV. PETITIONERS' BRIGHT-LINE CORRECTIVE-DISCLOSURE PRICE-DECLINE RULE WOULD UNDERMINE THE SECURITIES LAWS' FUNDAMENTAL PURPOSES

By every measure, the U.S. capital markets are the world's largest and strongest.[42] They are so attractive that some 900 foreign companies, from more than 40 different countries, list their securities for trade on our markets—not despite our securities laws, but *because of* them.[43] Private actions, long implied under §10(b), are crucial to the integrity of our disclosure system and markets because they provide a powerful deterrent to fraud, and are a necessary supplement to the

[42] "The U.S. capital markets continue to be the deepest, most liquid, and most efficient markets in the world." *Strengthing Accounting Oversight: Before the House Energy and Commerce Comm.* (July 26, 2002) (testimony by Edmund L. Jenkins, Chairman of the Financial Accounting Standards Board); "[W]e have the deepest and most liquid capital markets in the world." *Corporate Accounting Practices Review: The Rules of the SEC and FASB in Establishing GAAP: Hearing on H.R. 3763 Before the House Fin. Servs. Comm.* (May 14, 2002) (testimony by Robert K. Herdman, SEC Chief Accountant).

[43] *See* Jenkins Congressional testimony, *supra* (United States has deepest and most liquid markets "largely because of the high quality of our financial reporting system"). *See* http://www.nyse.com/pdfs/updatedforlist_041029.pdf (visited Oct. 29, 2004) (460 foreign companies from 47 countries); http://www.nasdaq.com/asp/NonUsOutput.asp (visited Oct. 29, 2004) (340 foreign companies, including eight additional countries not represented on the NYSE).

SEC's enforcement program.[44] Congress clearly recognized this in enacting the PSLRA.[45]

Our securities laws "'embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.'" *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 171 (1994) (quoting *Affiliated Ute*, 406 U.S. at 151). Yet by calling for a rule that sees loss causation only in a decline in price upon disclosure of the truth, Dura and its *amici* ask this Court to create perverse incentives rewarding those who, after perpetrating a fraud, continue concealing the truth. This surely contradicts the 1934 Act's core aim of full *disclosure* and informed markets.

While some securities-fraud cases proceed in simple fashion, with false statements followed by a sudden stock price drop on public revelations that the truth was otherwise, many other securities-fraud cases are not so simple. "Rarely is one outright lie revealed through one correction," leading authorities on event studies tell us, and because it often "is difficult to determine when corrective disclosure occurs," one can "unambiguously define the disclosure date and the associated disclosure price only in simple situations." Cornell & Morgan, *supra*, 37 U.C.L.A. L. Rev. at 889, 891, 896.

Many securities-fraud cases are factually complex. In this case, for example, defendants' (partial) disclosures impacting AlSpiros expectations were part of the original Ceclor CD

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[44] *Hearing on Securities Fraud Litigation Reform Proposals Before the Subcommittee on Telecommunications & Finance of the House Committee on Commerce*, 1, 30 (Feb. 10, 1995) (testimony of SEC Chairman Arthur Levitt).

[45] Contrary to what the Solicitor General and several *amici* say, despite their size and complexity securities cases go to trial about as often as any other type of civil case. Only 1.7% of federal civil cases, in general, actually reach trial according to the most recent *Federal Judicial Caseload Statistics* compiled by the Administrative Office of the United States Courts.

disclosure discussing the sales force inadequacy and then dribbled out for months after the Class Period's close—with the final announcement itself condemned by the FDA months after the Class Period's close.[46] Dura's proposed rule—requiring a decline in price on disclosure of wrongdoing—ignores the fact that defendants who falsified a company's condition, and lied about its finances, products or prospects might refuse to "come clean," never admitting that they said or did anything wrong.

Under the Sarbanes-Oxley Act Congress recently extended the limitations period for §10(b) claims to two years from discovery and *five years from the violation*. Legislative history shows Congress adopted the five-year period of repose precisely because securities fraud is so hard to discern. The statute-of-limitation amendment's co-sponsor, Senator McCain, explained that the existing three-year period was too "short given the complexity of many of these matters, and defrauded investors may be wrongly stopped short in their attempts to recoup their losses under current law. . . . Because this statute of limitations is so short, the worst offenders may avoid accountability and be rewarded if they can successfully cover up their misconduct for merely three years. The more complex the case, the easier it will be for these wrongdoers to get away with fraud." 148 Cong. Rec. S6528-29 (July 10, 2002). He emphasized that "in some cases, the facts of a case simply do not come to light until years after the fraud." *Id.* The amendment's chief sponsor, Senator Leahy, added that "the law should not reward the perpetrator of a fraud, who successfully conceals its existence for more than three years." 148 Cong. Rec. S7418-20 (July 26, 2002).

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[46] JA111a (¶136) (quoting FDA letter described in Respondents' November 17 letter).

Moreover, as noted above, by merely delaying disclosure, those who commit fraud may minimize its apparent impact. *See supra*, n.8. Over time inflation due to fraud ages out of a stock's price. *Id.* A rule that damages must be measured only to the extent of a *subsequent drop* on disclosure of the truth would perversely reward those able to conceal their fraud the longest If a company reveals that last quarter's revenues were deliberately overstated by 20%—in order to show a profit, when the company had really suffered a loss—one would expect an immediate and strong market reaction. The reason is that future expectations are based, in part, on what is currently believed the base to grow on. A 20% overstatement in the quarter just completed would render the market's discounted cash flow models flawed and overstated. The stock would tumble. If the company waits several years before finally admitting to the fraud, the impact will not be the same—even if it discloses that its revenues were deliberately inflated for a single quarter four-and-a-half years ago. Like the headline of a recent article in *The New York Times* says: "Yesterday's Earnings Don't Move Stocks, Tomorrow's Do," Jonathan Fuerbringer, *N.Y. Times*, Aug. 8, 2004; *see also* Lynn Cowan & Shaheen Pasha, "Investors Focus on Future Results and Forgive Past Performance," *Wall St. J.*, Apr. 24, 2002; NERA Presentation, *supra*, n.8.[47]

Dura ignores something more: "Executives can be marvelously creative when they have to disclose disappointing

[47] The Securities Industry Association complains that the Ninth Circuit's refusal to require a corrective disclosure followed by a stock drop would allow plaintiffs to survive a Rule 12(b)(6) motion to dismiss in a situation wherein a $200 investment gradually declines to $20—and remains at $20, despite the defendant's sudden announcement of an accounting restatement. Securities Industry Ass'n Brief at 3. Our response, however, is simple. If the stock was really worth $100 but investors paid $200, investors should recover the $100 overpayment. Otherwise insiders that inflated the stock price and cashed out can immunize themselves with additional false statements and/or delay.

results to investors." Gretchen Morgenson, "Finding Holes in Corporate Excuses," *N.Y. Times*, Aug. 1, 2004. A disclosure's negative effect may be obscured by defendants who downplay its significance, who pair the bad news with good, *or who lie again*. *See, e.g., No. 84 Employer-Teamster Joint Council Pension Tr. Fund v. Am. West Holding Corp.*, 320 F.3d 920, 934-35 (9th Cir. 2003); *Gray v. First Winthrop Corp.*, 82 F.3d 877, 882-83, 886 (9th Cir. 1996); *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 966 (7th Cir. 1989) ("a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counterbalancing the loss") (Easterbrook, J.). Here, of course, Dura's November 3, 1998, press release downplayed the product's failure so blatantly that the FDA cited it. JA110a-111a (¶136); *see* Nov. 6, 1998, FDA letter.

Thus, Dura's proposed rule would give those who choose to commit fraud many opportunities to game the system, and to avoid liability with manipulative disclosures. *See* Eisenhofer, *supra*, 59 Bus. Law. at 1443.

The loss-causation issue is in play only if a defendant has already told one lie, *i.e.*, a lie that inflated the price of the stock for some period of time while investors were purchasing it. Telling two lies will, under the bright-line causation rule sought by petitioners and their *amici*, allow lying insiders to avoid liability. There is no room under our securities laws for a rule that encourages corporate insiders to tell a second lie to avoid liability for their first lie. Yet, that is exactly what the loss-causation rule argued for by Dura and its *amici* would produce.

For example, a stock may decline, before any disclosure, as insiders bail out. In *Dirks v. SEC,* 463 U.S. 646 (1983), this Court noted that surreptitious stock sales by investors with access to adverse inside information regarding a company's accounting improprieties drove its stock from $26 per share to less than $15 per share in two weeks—causing the New

York Stock Exchange to halt trading—before any public disclosure of the accounting fraud. *Id.* at 649-50; *see Dirks v. SEC*, 681 F.2d 824, 831-32 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983). In *SEC v. Shapiro*, 494 F.2d 1301, 1307 n.3 (2d Cir. 1974), trading by insiders who knew of undisclosed favorable information "pushed the price of [the] stock by February 18 to nearly three-and-one-half times what it had been at the beginning of the year."

Petitioners' proposed rules could make it hardest for victims of the most egregious frauds to plead a claim. Such rules should be rejected.

CONCLUSION

The statute at issue in this case is plain on its face: It does not raise the pleading standards as to loss causation in open-market fraud cases. Moreover, there is more than one way to prove loss causation—which traditionally requires a showing only that the price paid was inflated by fraud at the time of the transaction. A contrary rule, that allows defendants to reduce liability through continued misrepresentations or concealment, should be flatly rejected. The judgment of the Ninth Circuit should be affirmed.

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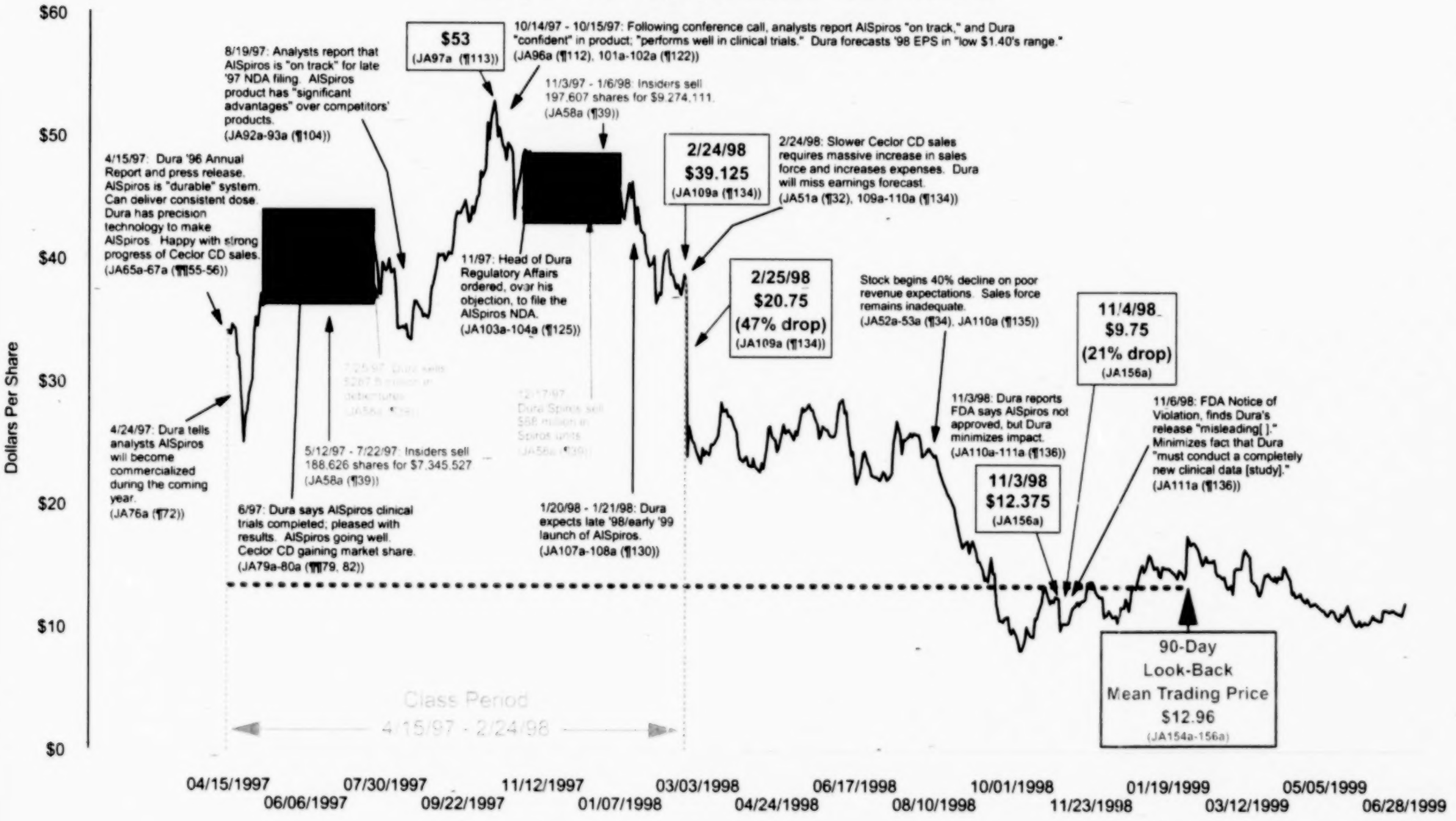
Daily Share Prices: April 15, 1997 - June 30, 1999



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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF

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STATEMENT PURSUANT TO RULE 29.6

Petitioner's Rule 29.6 Statement was set forth at page *ii* of Petitioner's Opening Brief, and there are no amendments to that Statement.

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INTRODUCTION

The price inflation theory urged by respondents and adopted by the Ninth Circuit has been aptly summarized by petitioners and the Securities and Exchange Commission ("SEC") as one which improperly removes the fundamental "loss" component from "loss causation" – one of the elements necessary to successfully plead and prove a securities fraud claim under Section 10(b). Respondents argue that all they need allege is that a security was inflated when it was purchased, whether or not the alleged "loss" was ever realized. This result would negate entirely the necessity of pleading the loss causation element at all.

Respondents' price inflation theory cannot be reconciled with the loss causation provisions of the Reform Act, which specifically require that a plaintiff plead and prove "that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). Nor is it consistent with (1) the overall statutory scheme of the Reform Act, which contains a limitation of damages provision that defines a plaintiff's damages in terms of a post-transaction decline in value following a corrective disclosure, (2) the loss causation provision of Section 105 of the Reform Act, which expressly defines loss causation in terms of a direct link between a defendant's misconduct and a "depreciation" in the value of stock or (3) Section 28 of the Securities Exchange Act of 1934, which provides that a plaintiff may not recover an "amount in excess of his actual damages on account of" a violation of the securities laws. 15 U.S.C. § 78bb(a). Moreover, respondents have never addressed the fundamental inconsistency between their price inflation theory and the failure of an efficient market to record a decline when a correction is made.

Respondents' suggestion that the majority rule sought by petitioners would be disastrous for investors and the integrity of our securities markets is best measured against the position in this case of the principal Government agency charged with

securities law enforcement, the SEC. The SEC's view is that respondents' price inflation theory is wrong, contrary to the Reform Act, and one which would lead to improper windfalls for plaintiffs while deterring beneficial securities activities.

I. THE REFORM ACT CLEARLY REQUIRES THAT PLAINTIFFS PLEAD AND PROVE LOSS CAUSATION

In passing the Reform Act, Congress sought to establish uniform and stringent requirements for putative securities fraud actions arising under Section 10(b). Pet. Br. at 14-15. To that end, Congress codified a plaintiff's burden of pleading and proving "loss causation" in Section 21D(b)(4) of the Reform Act. 15 U.S.C. § 78u-4(b)(4).

A. Respondents' Price Inflation Theory Is Not Consistent With The Reform Act's "Look Back" Provision

Respondents acknowledge that at the same time Congress codified loss causation in the Reform Act, it also implemented an upward damages limitation in Section 21D(e)(1), which provides that:

> in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which *the information correcting the misstatement or omission that is the basis for the action is disseminated to the market*.

15 U.S.C. § 78u-4(e)(1) (emphasis added). Petitioners have previously detailed how respondents' price inflation theory, which requires no stock price decline, is fundamentally inconsistent with a "look back" provision designed to limit

plaintiffs' potentially available damages where a stock does not decline, or declines but then recovers. Pet. Br. at 15-17.

Remarkably, respondents argue (at 38) that, rather than negating their theory, the "look back" provision evidences Congress' intent to "fix loss" at the time the security is purchased at an inflated price. On the contrary, the "look back" provision makes clear that the loss is analyzed in terms of "the difference between" the inflated purchase price and "the trading price" *after* the misrepresentation is corrected. This damages provision thus comports precisely with the majority rule, not respondents' theory. *See Reno v. Koray*, 515 U.S. 50, 56 (1995) (a court must interpret a statute as a coherent harmonious whole).

Respondents also mistakenly assert (at 38-41) that the "look back" provision will prevent the inevitable windfalls to plaintiffs under their price inflation theory. In doing so, respondents evidence a fundamental confusion between liability and damages. (Amicus Regents of the University of California (at 9) actually calls it "immaterial" whether investment loss is considered an element of liability or of damages.) Leaving the determination of whether a plaintiff suffered a loss to the damages stage gets things backwards. Congress determined that a defendant cannot be liable for securities fraud unless it caused the plaintiff to incur a loss. 15 U.S.C. §§ 78u-4(b)(4), 78bb(a). Thus, an investment loss caused by the alleged fraud is an element of liability, not merely an issue to be determined when calculating the amount of damages. Respondents and their amici seek to leap over their burden to plead and prove the proper causal nexus as part of their liability case and suspend it until the damages computation stage. There is no basis, however, for a damages proceeding where the defendant did not cause the plaintiff any loss. *See Simon v. First Interstate*, 516 F.2d 303, 306 (2d Cir. 1975) (the "rule that uncertainty as to the amount of damages is to be cast on the wrongdoer does not extend to uncertainty as to the fact of damages"). Moreover, postponing the necessary inquiry until the final stage of litigation would

open the door to coercive class action settlements in the vast majority of cases that do not proceed to trial.

B. Respondents' Price Inflation Theory Is Not Consistent With Section 105 Of The Reform Act

At the same time it codified the required element of loss causation for securities fraud actions under the Exchange Act, in Section 105 of the Reform Act, Congress also codified the element of loss causation as applied to private actions brought under Section 12 of the Securities Act of 1933. PL 104-67 § 105; 15 U.S.C. § 77l(b). Section 105 clearly defines "loss causation" in terms of the direct link between defendants' false statements and the "depreciation in value of the subject security. . . ." Pet. Br. at 18-21. Consequently, Congress intended that price inflation without a decline would not be a "loss" for purposes of loss causation.

Respondents do not and cannot dispute that Section 105 defines loss causation in this fashion. Respondents instead discourse upon the differences between Section 12 and Section 10(b). Resp. Br. at 35-38.[1] Although Respondents spend a great deal of time distinguishing between "out of pocket" damage measures frequently associated with Section 10(b) and rescissory-based damages under the 1933 Act, respondents concede (at 36-37) that Section 10(b) claims may also be subject to rescissory measures, thus obviating the ostensible point of their distinction. *See also Randall v. Loftsgaarden*, 478 U.S. 647, 661-62 (1986). The significance of the *definition* of loss causation in Section 105 to mean "depreciation" is in any event not affected by what measure of damages is employed, and whether they are "out of pocket" or "rescissory." Rather, Section 105 defines the nature of "loss" itself and instructs how that loss must be manifested and caused.

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1. In prior interpretations of the federal securities laws, this Court has comprehensively analyzed the broad statutory scheme. *See, e.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 174-80 (1994); *Chiarella v. United States*, 445 U.S. 222, 234 (1988).

No aspect of respondents' argument can overcome the fact that Congress in the Reform Act stated that loss causation requires a "depreciation in value of the subject security resulting from" the alleged violation. If Congress intended loss causation to have a vastly different meaning elsewhere in the same Reform Act, it would have said so. *See Colautti v. Franklin*, 439 U.S. 379, 392 (1979) (Congress "presumably" intended statutory definition "to be the exclusive definition ... throughout the Act"); *Meese v. Keene*, 481 U.S. 465, 484 (1987). Were respondents' price inflation rule to be adopted, it would result in two different definitions of loss causation within the Reform Act, thereby violating fundamental principles of statutory construction. *Id.*; *see also Sorenson v. Secretary of the Treasury*, 475 U.S. 851, 860 (1986) ("identical words used in different parts of the same act are intended to have the same meaning").

C. Respondents' Price Inflation Theory Is Not Consistent With Pre-Reform Act Provisions Of The Federal Securities Laws

Respondents incorrectly argue that the Exchange Act codified their price inflation rule. Resp. Br. at 16-17. On the contrary, the measure of damages in claims under Section 10(b) is governed by Section 28(a) of the Exchange Act, which provides that an investor may not recover an "amount in excess of his *actual damages on account of*" a violation of the securities laws, meaning the investor's actual monetary loss. 15 U.S.C. § 78bb(a) (emphasis added); *see Randall*, 478 U.S. at 662-63; *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154-55 (1972). Respondents' price inflation rule is inconsistent with "actual damages on account of" or attributable to specific misrepresentations or omissions which can be linked to the alleged loss. Respondents' theory could make defendants potentially liable not only to those investors who can prove a price decline caused by the defendants' conduct, but also to investors who did not lose money as a result of the defendants' conduct, because they sold before the conduct was exposed and the price dropped or because the price dropped for other reasons.

It would also allow recovery by plaintiffs who proffer only speculative theories of loss causation and whose losses are attributable to extraneous market flucuations. *See* S. Rep. No. 104-98 at 7 (1995), *reprinted in* 1995 U.S.C.C. A.14, 679, 686. The majority loss causation rule, by contrast, is fully consistent with the statute's "actual damages on account of" requirement. This rule makes damages available only to investors who can show that the losses they suffered were "on account of" specific misrepresentations or omissions made by the defendant, as demonstrated by a distinct market price adjustment upon disclosure of the specific, correct information. When price declines have other causes, such as publicly available information about other, nonfraudulent facts about the company, the industry, or the general market, such declines are not "actual damages" caused by the defendant.[2]

Not surprisingly, respondents' argument ignores Section 28(a) entirely and instead relies exclusively on an analogy to Section 9(e) of the Exchange Act, which governs market manipulation activities, including transactions by issuers in their own securities. 15 U.S.C. § 78i. Respondents selectively cite dicta from *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 46 (1977), for the proposition that Section 9(e) speaks in terms of the recovery of an "improper premium" over the price the security would have traded at absent the manipulation. *Piper* actually involved standing to sue under Rule 10b-6, and the Court expressly stated that Section 9(e) is *"[u]nlike § 10(b)"* by providing for an express cause of action "in favor of 'any person who shall purchase or sell any security at a price which was affected by such act or transaction.'" 430 U.S. at 46 (emphasis added).[3] When Congress amended Section 10(b) in the Reform

2. For additional discussion of Section 28(a) and related damage limitations under the securities laws, *see* the Amicus Briefs of the SIA at 14-17 and Merrill Lynch at 7-11.

3. This Court's reference to Section 9 in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977), was solely for the purpose of identifying manipulative practices in the securities markets, and the Court declined to apply it to the plaintiffs' Section 10(b) claims.

Act, it did not reproduce the Section 9(e) language, instead requiring plaintiffs to plead and prove that the defendant's act or omission "caused the loss for which the plaintiff seeks to recover damages", a requirement which as a consequence of the Reform Act is now equally applicable to Section 9(e).[4]

In any event, a market manipulation case is fundamentally different from a fraud on the market case. In a manipulation case, if there was harm, the stock declines when the manipulation ceases, even if both the manipulation and its cessation remain unknown. There is no open market reaction to a public event to show if there was harm and how much. In a fraud on the market case, if there was fraud, the stock price declines only when the market learns of corrective information. The market's reaction shows both if there was harm and is indicative of how much.

D. The Legislative History Does Not Evidence That Price Inflation Alone Is Sufficient To Plead And Prove Loss

Legislative history is resorted to only when necessary to interpret ambiguous statutory text. *See, e.g., Bedroc Limited, LLC v. United States*, 541 U.S. 176, 124 S. Ct. 1587, 1593

4. The loss causation requirement applies to "any private action arising under" Title I of the Exchange Act. 15 U.S.C. § 78u-4(b)(4). Respondents' reliance upon Section 9(e) is ironic given that plaintiffs routinely avoid using that provision because of its difficult proof requirements. *See* IX Loss & Seligman, SECURITIES REGULATION 4280 (3d ed. 2004) (Section 9(e) "has been virtually a dead letter so far as producing recoveries is concerned"). Loss & Seligman also refer to uncertainty whether Section 9(e) requires apportionment of market losses between recoverable losses caused by manipulation and non-recoverable ones attributable to other causes, noting that the "apportionment concept may be inherent in the phrase, 'sustained as a result,' in § 9(e)" or in "the phrase, 'at a price which was affected by.'" *Id.* at 4281 n.200. If Section 9(e) was more than a "dead letter," no doubt courts would have had to consider loss causation standards to be derived from the "affected by" and "sustained as a result" phrases closely, which this Court had no need to do in its dicta in *Piper*. In short, a little-used provision that was not Congress' focus in the Reform Act is not informative of loss causation under Section 10(b).

(2004). The Reform Act's loss causation requirements, including the definition of Section 105 requiring "depreciation," are not ambiguous and no such reference is necessary. In any event, legislative history plainly supports petitioners' interpretation. Pet. Br. at 22-26.

Respondents point to references in the legislative history to "artificial inflation." Resp. Br. at 25-30. That there are such references is hardly surprising because if there was no inflation, corrective information will not cause depreciation.[5] In order to conclude from those references, however, that artificial inflation is all that need be demonstrated to establish loss, respondents depend upon an inappropriately selective treatment of the legislative history.

For example, respondents (at 28) rely upon a May 11, 1995 letter from SEC Chairman Arthur Levitt to Senator Richard Bryan describing S. 240 as making it clear that "plaintiff is required to prove that the misstatement or omission caused his loss; i.e., that the price at which the plaintiff purchased his shares was artificially inflated as a result of the misstatement or omission." But Chairman Levitt went on to make clear his understanding that liability under Section 10(b) depends on there being:

> no other factors, unrelated to the fraud, *that contributed*

5. Consequently, it is hardly informative that analyses of early House and Senate bills suggested "plaintiff has the burden of showing that the misstatement or omission caused the loss" (141 Cong. Rec. S1086-87 (Jan. 18, 1995) or that plaintiffs would have to establish that defendant's misstatement or omission "established the market price at which the plaintiff purchased or sold the securities in question." *Id.* None of these propositions suggest that plaintiffs need not demonstrate actual loss. Further, it is puzzling that respondents make reference to the Banking Committee's deleted amendment to the Senate bill regarding defendants' ability to mitigate damages alleged by plaintiff by showing that other factors contributed to the loss. Resp. Br. at 28. The deletion of the sentence in Conference demonstrates either an intent by Congress not to adopt respondents' position or Congress' understanding that loss causation made such a mitigation defense redundant. *Id.*

> *to a decline in share price following the disclosure of corrective information.*[6]

It is in this context – clearly presupposing a decline in share price following a corrective disclosure– that the House Conference Report confirmed that plaintiffs were required to plead and prove "that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff" (H.R. Conf. Rep. 104-369 at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 740),[7] and that the Senate Report stated that the loss causation requirement was "codifying the requirement under current law that plaintiff prove that the *loss in the value of their stock* was caused by the Section 10(b) violation and not by other factors." S. Rep. No. 104-98 at 7 (1995), *reprinted in*

6. Letter from Arthur Levitt to Senator Richard Bryan, at 8 (May 11, 1995) (described in respondents' November 17 letter) (emphasis added).

7. Predictably, respondents emphasize the example cited in the Conference Report that plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as a result of the misstatement or omission." Resp. Br. at 29-30 (citing S. Rep. No. 104-98, at 7, 15). Again, as the SEC observed "it is not likely that this lone sentence . . . reflects a considered congressional judgment as to the standard for establishing loss causation in a Rule 10b-5 case." U.S. Br. at 27. The SEC explains:

> A contrary conclusion would be particularly unwarranted in light of the statement in a different portion of the same Senate Report that the loss-causation provision of the 1934 Act "codif[ies] the requirement under current law that plaintiffs prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors."

Id.; *see also Timbers*, 484 U.S. at 380 (generalizations contained in legislative history are inadequate to overcome the plain textual meaning contained elsewhere in the statute). Respondents' cite to *Basic* in support of their rule again confuses the transaction causation addressed in *Basic* with loss causation. Resp. Br. at 30 (citing 485 U.S. at 243-45).

1995 U.S.C.C.A.N. 679, 686 (emphasis added). "[L]oss in the value their stock" must mean depreciation.[8]

E. Respondents' Attempts To Distinguish The Burdens Of "Pleading" And "Proof" Under The Reform Act Are Disingenuous

In order to evade application of the loss causation standard, respondents now assert the counterintuitive premise that the Reform Act requires only that they prove loss causation, but not that they satisfactorily plead loss causation in their complaint. Resp. Br. at 30-34. Respondents posit this result because Section 21D(b)(4) speaks in terms of "proof" and does not expressly state "pleading." This is a false distinction.

First, loss causation has been recognized as a required element of a securities fraud claim under Section 10(b) for at least thirty years. *See Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974). To suggest that an element of a securities fraud claim need not be pleaded is a non-starter.[9] Second, as the SEC explains, loss causation as an element of a fraud cause of action, must be stated with particularity under

8. In light of the clear statutory scheme discussed, *supra*, at 2-5, any ambiguity respondents suggest with respect to selected portions of the Reform Act's legislative history merely means that such history is not a useful tool for statutory interpretation in this case. *See Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 413 n.29 (1971) (where the legislative history is ambiguous, the Court must look to the statutes themselves to find the legislative intent).

9. *See Santa Fe Industries., Inc. v. Green*, 430 U.S. 462, 469 (1977) (reversing Second Circuit's pleading determination that plaintiffs stated a claim under Section 10(b) and Rule 10b-5 holding that mere corporate mismanagement was not within the statute or rule); *see also Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727 (1975) (reversing Ninth Circuit's determination of standing at the motion to dismiss stage, holding that private actions under Rule 10b-5 were limited to actual purchasers or sellers of securities); *cf. Valley Forge Christian College v. Americans United For Separation Of Church And State, Inc.*, 454 U.S. 464, 486-87 (1982) (reversing Court of Appeals decision reversing district court's dismissal of action, holding that plaintiff failed to identify any personal injury suffered by it as consequence of the alleged wrong).

Fed. Rule Civ. Proc. 9(b). U.S. Br. at 15. In addition, it is hornbook law that a complaint must contain either direct allegations on every material point necessary to sustain a recovery or allegations from which an inference fairly may be drawn that evidence on these materials points will be available and introduced at trial. 5 C. Wright & A. Miller, FEDERAL PRACTICE & PROCEDURE § 1216 (3d ed. 2004).[10]

Third, even if there were any ambiguity about the requirement, the Conference Committee report clearly states with respect to "Loss Causation":

> The Conference Committee also requires the plaintiff to *plead and then* to prove that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff in new Section 21D(b)(4) of the 1934 Act.

H.R. Conf. Rep. No. 104-369, at 41 (emphasis added); *see* S. Rep. No. 104-98, at 15 (addressing loss causation under heading "A strong pleading requirement"); *see also D.E. & J Ltd. Partnership*, 284 F. Supp. 2d at 746-47 ("The legislative history of the [Reform Act] makes it clear that this is a pleading requirement"). Moreover, it is indisputable that the Reform Act was expressly designed to impose higher pleading standards in order to weed out abusive and frivolous securities lawsuits. *See United Savings Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988) (provisions that may seem ambiguous in isolation are often clarified by the remainder of the statutory scheme).[11]

10. *Swierkiewicz v. Sorema, N.A.*, 534 U.S. 506 (2002) (Resp. Br. at 30 n.29) is not to the contrary. It applied Rule 8(a)'s simplified pleading standards to an employment discrimination claim and expressly distinguished its holding from fraud cases governed by Rule 9(b); *see also Bass v. E.I. DuPont de Nemours & Co.*, 324 F.3d 761, 764-66 (4th Cir. 2003) (*Swierkiewicz* did not remove plaintiff's burden to allege facts sufficient to state all elements of a claim). *Id.* at 512-13.

11. That other provisions expressly impose heightened pleading requirements with respect to the specific fraudulent statements and

(Cont'd)

As previously outlined by petitioners (at 4-11; *see also* U.S. Br. at 28-29), respondents' complaint contains no direct allegations that the alleged fraud concerning Albuterol Spiros caused them to incur an investment loss nor allegations raising an inference that respondents could prove such loss causation at trial. Indeed, the complaint references only one price decline, and it occurred *before* disclosure of any corrective information about Albuterol Spiros. Just as a court may not assume that a plaintiff "can prove facts that it has not alleged" (*Associated Gen. Contractors*, 459 U.S. at 526), a court may not assume that a plaintiff can prove an essential element of a claim for which it alleges no factual or legal basis.

Respondents further argue (at 33) that "leaving loss causation for proof at trial makes sense." But that is not a legitimate basis for relieving plaintiffs of the obligation to plead loss causation. If the plaintiff must prove that a defendant's act or omission "caused the loss for which the plaintiff seeks to recover damages," as the Reform Act mandates, it makes no sense to wait until trial – after the expenditure of vast court and party resources – to learn that the plaintiff has no good-faith basis for asserting the necessary causal element of their claim. As respondents concede in even advancing this argument, the very problem targeted by Congress in the Reform Act is that, because of the immense pressure to settle, few securities fraud class actions ever get to trial. Once a securities fraud class action

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scienter does not show, as respondents assert (at 31-34), that the loss causation provision does not relate to pleading. Numerous courts have not hesitated to impose it as a pleading requirement. *See, e.g., In re Atlas Air Worldwide Holdings, Inc., Sec. Litig.*, 324 F. Supp. 2d 474, 497 (S.D.N.Y. 2004) (15 U.S.C. § 78u-4(b)(4) requires that plaintiffs "adequately allege a causal connection between the misleading statements or omissions and the decline in value of the securities at issue."); *In re QLT Inc. Sec. Litig.*, 312 F. Supp. 2d 526, 536 (S.D.N.Y. 2004); *D.E. & J Ltd. Partnership v. Conaway*, 284 F. Supp. 2d 719, 746-47 (E.D. Mich. 2003); *Lillard v. Stockton*, 267 F. Supp. 2d 1081, 1109 (N.D. Okla. 2003); *In re Livent, Inc. Sec. Litig.*, 148 F. Supp. 2d 331, 365 (S.D.N.Y. 2001).

survives a dispositive motion, it has a "settlement value to the plaintiff out of any proportion to its prospect of success." *Blue Chip Stamps*, 421 U.S. at 740. That *in terrorem* effect would be heightened if putative class representatives could delay the loss causation inquiry until trial and thereby avoid their burden to show that they can prove investment losses on a class-wide basis. The result would be "extortionate settlements" from which "[i]nvestors always are the ultimate losers." H.R. Conf. Rep. No. 104-369, at 32 (1995).

F. Respondents' Argument That Pre-Reform Act Section 10(b) Precedents Applied Their Price Inflation Theory Is Wrong

Respondents rely upon this Court's references to causation in *Affiliated Ute* and *Basic*, in order to suggest that their theory of loss causation has been embraced previously by this Court and other courts and was the "current law" codified by the Reform Act. Resp. Br. at 13, 25. These precedents, however, do not address loss causation at all.

For example, *Affiliated Ute* involved a direct action by *sellers*, not purchasers, against market makers who purchased stock when they knew and had a duty to disclose that higher prices were available. 406 U.S. at 153. *Affiliated Ute* did not involve, as this case does, an efficient market and the fraud on the market theory; moreover, unlike purchasers, sellers are not affected by post-transaction changes in price. Any seller's loss is fixed and final at the time of the sale. The Court did not discuss loss causation, but rather what would lead a "reasonable investor" in "the making of [its] decision" to invest in a security (406 U.S. at 154) *i.e.*, transaction causation — not loss causation.[12]

12. Respondents' repeated reliance upon the reference to the "causational chain" in *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975) is similarly misplaced, as it primarily addressed transaction causation in a class certification context and whether an investor need demonstrate individual reliance upon a misrepresentation in an efficient market. To the extent it did otherwise, a collapse of loss causation into

(Cont'd)

Like *Affiliated Ute*, the plaintiffs in *Basic* were sellers, not purchasers, who sold in advance of an undisclosed merger, and consequently, the case did not involve consideration of a post-transaction decline in price. More importantly, in *Basic* this Court was not addressing loss causation at all, but the rebuttable presumption of reliance – or transaction causation in an efficient market. 485 U.S. at 246-47 (investor's reliance on any public material misrepresentations may be presumed for purposes of a Rule 10b-5 action); *see Robbins v. Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997) (fraud on the market theory articulated in *Basic* is not presumption of loss causation). Thus, neither *Affiliated Ute* nor *Basic* demonstrate any application of respondents' price inflation theory at all prior to the Reform Act nor do they offer any other support to respondents.[13]

(Cont'd)

transaction causation was the type of outcome members of Congress were attempting to thwart with the Reform Act. Pet. Br. at 29 n.9. Moreover, contrary to respondents' suggestion, statements in *Blackie* about how loss might be determined were entirely dicta, 524 F.2d at 909 n.25, as is the concurrence of Judge Sneed *in Green v. Occidental Petroleum Corp.*, 541 F. 2d 1335, 1344 (9th Cir. 1976) (also reviewing class certification).

13. Respondents' citation (at 21) to Judge Posner's opinion in *Isquith v. Caremark Int'l, Inc.*, 136 F.3d 531 (7th Cir. 1998), for this same proposition is highly misleading. Judge Posner does not define loss causation as the "discrepancy between actual market value" and what the value would have been absent the fraud, but as the "loss produced by" the discrepancy. As he makes clear immediately after the quote respondents rely upon, loss causation would be a "resulting drop in the value of [securities] when the truth emerged." 136 F.3d at 535. The opinion authored by Judge Easterbrook in *Pommer v. Medtest Corp.*, 961 F.2d 620, 628 (7th Cir. 1992) is also of no assistance to respondents as it involved neither an efficient market nor even publicly traded securities. Finally, *Scattergood v. Perelman*, 945 F.2d 618 (3d Cir. 1990) has been interpreted by *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000), to be consistent with the proposition that "where the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation." 223 F.3d at 184-85.

Resp. Br. at 25. Respondents' suggestion that their price inflation theory constituted the "current law" codified by the Reform Act is bereft of any support.[14]

G. Respondents' Common Law Tort Precedents Do Not Govern Implied Rights Of Action Under Section 10(b)

Respondents devote considerable attention to common law fraud and deceit precedent from the turn of the century, for the proposition that their statements about the measure of damages arising under tort law comport with their price inflation theory. Resp. Br. at 13-15. Nineteenth century tort law, however, is not relevant here.[15] As this Court stated in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable" because it involved face to face dealings and not impersonal transactions potentially involving "tens of millions of investors." 421 U.S. at 744-45.

To rely upon these common law cases to supply the loss causation rule under the Reform Act is to ignore the teachings

14. Respondents' related assertion (at 41) that only post-Reform Act cases have held that loss causation requires more than proof of an inflated purchase price is clearly wrong. *See, e.g., Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 450 U.S. 375 (1983); *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir. 1990); *see also* Pet. Br. at 23-26. Clearly, these decisions constituted the relevant "current law" on loss causation when the Reform Act was enacted.

15. Moreover, the very precedents cited by respondents (at 14-15) undermine their price inflation theory. *See, e.g., Smith v. Bolles*, 132 U.S. 125, 130 (1889) ("The damage to be recovered must always be the natural and proximate consequence of the act complained of" and "must have been contemplated as the probable consequence of his fraud"); *Sigafus v. Porter*, 179 U.S. 116, 125 (1900) (damages include amounts "legitimately attributable to the defendant's conduct, but not damages covering the expected fruits of unrealized speculation").

of cases from *Blue Chip Stamps* to the Reform Act itself[16] that constraints upon Section 10(b) claims, including those that make it easier "to dispose of [meritless cases] before trial" (*Basic*, 423 U.S. at 742-43), are essential to curb abusive suits and that common law analogues cannot just be superimposed on Section 10(b). It would also ignore the principles underlying this Court's consistent refusal to allow damages actions to proceed on the basis of speculative and indeterminate damage theories.[17] The Reform Act's purpose of ensuring that "plaintiffs prove the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors" is inconsistent with borrowing weak common law conceptions of loss causation. S. Rep. No. 104-98 at 7 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 686.

Finally, the common law at the time of the 1995 Reform Act was, from respondents' viewpoint, at best equivocal. As previously shown (Pet. Br. at 31-33) both Prosser & Keeton and the Restatement (2d) of Torts contain examples where there

16. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (declining to extend Section 10(b) actions to negligent conduct); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (limiting claims under Section 10(b) and 14(a) to materially misleading omissions); *Santa Fe*, 430 U.S. 462 (1977) (Rule 10b-5 does not extend to mere instances of corporate mismanagement); *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 5-8 (1985) (limiting claims under § 14(e) to manipulative acts involving misrepresentations or nondisclosure); *Central Bank of Denver*, 511 U.S. 164 (1994) (private plaintiff may not maintain aiding and abetting suit under Section 10(b)).

17. *See Blue Chip Stamps*, 421 U.S. at 734-35 (limiting Section 10(b) action to purchasers and sellers of securities because causation of injury to others would be "conjectural and speculative"); *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1105-1106 (1991) (refusing to extend Section 14(a) private action to shareholders whose proxy was unnecessary to approval of a transaction to avoid "speculative claims" in which "[c]ausation would turn on inferences" that would be "hazy" and "unreliable"); *Dirks v. SEC*, 463 U.S. 646, 667 n.27 (1983) (declining to give weight to claims of shareholder losses where there was "no clear causal connection between inside trading and outsiders' losses"); *Holmes v. SIPC*, 503 U.S. 258, 268-69 (1992) (precluding recovery of losses that are too indirect, remote or speculative).

is no causation even though there was unquestionably price inflation.

II. RESPONDENTS' PRICE INFLATION THEORY DOES NOT FURTHER THE PURPOSES OF THE SECURITIES LAWS

Respondents suggest (at 9) that the rule urged by petitioners would be "disastrous both for investors and the integrity of our securities markets." Significantly, the SEC, the agency charged with administering and enforcing the securities laws and which has "a strong interest in seeing that the principles applied such actions promote the purposes of the securities laws," holds the opposite view. According to the United States, the Ninth Circuit loss-causation standard is incorrect, and "loss" means a decline in value of the security, and in a fraud-in-the-market case, that necessarily occurs at some point after the security has been purchased. U.S. Br. at 21-22. As the Government observes, respondents' theory renders loss causation effectively indistinguishable from transaction causation, and is inconsistent with the "very idea" of loss causation, that a "plaintiff has no right to recover merely because he purchased a security on false pretenses." *Id.* at 22-23; *see* Conference Report at 31 (Congress sought to prevent "routine filing of lawsuits against issuers ... whenever there is a significant change in an issuer's stock price").

Both petitioners and the United States have warned of the impermissible windfalls that will result if loss is determined at the time of purchase without regard to actual injury, and that such an interpretation puts "issuers in the position of insuring shareholders and purchasers against normal market risk." U.S. Br. at 22, 25; Pet. Br. at 34; *see also* Amicus Brief of SIA at 18-23 (detailing damaging effects of respondents' price inflation theory on the national securities markets).[18] Given that

18. *See also In re Cendant Corp. Litig.*, 264 F.3d 201, 228 n.8 (3d Cir. 2001) (rejecting windfalls associated with such an approach); *Piazza v. Ebsco Industries, Inc.*, 273 F.3d 1341, 1353-54 (11th Cir. 2001) (accord).

federal and state officials and self-regulating organizations have broad criminal and administrative powers to detect and punish fraud, there is no reason to think securities fraud would go unaddressed if the Court adopts the SEC's and petitioners' position. *See* Amicus Br. of Merrill Lynch at 24-30.[19]

Respondents and their amici pretend that a failure to adopt a lax loss causation standard will leave investors without a remedy when a stock declines or completely crashes. Section 10(b), however, does not provide a remedy for every stock price decline. The requirement that plaintiffs plead a price decline attributable to the disclosure of the fraud serves the critical statutory purpose of limiting Rule 10b-5 liability to losses a plaintiff suffers as a direct result of the misrepresentations. In the absence of this requirement, Section 10(b) would become "'a scheme of investors' insurance.'" *Basic*, 485 U.S. at 252 (White, J., concurring in part).

Assertions that culpable defendants will be dismissed if respondents' view of loss causation is not adopted are baseless. Respondents and their amici argue that if a rule were adopted that precluded recovery under Section 10(b) where the value of a stock goes to zero before a fraud is revealed and a corrective disclosure occurs, this result would somehow contravene the purposes of the securities laws. On the contrary, in such a case the cause of the stock's decline, and plaintiff's loss, was something other than the fraud and there should be no viable claim for securities fraud in that context. For example, if a buggy whip company had made misrepresentations that its buggy whips

19. Respondents also argue (at 47) that they should be relieved of pleading an investment loss because the five-year statute of repose might lapse before a plaintiff realizes that it has incurred a loss due to the alleged fraud. This is fanciful given that both stock price declines and corrective disclosures are public events monitored closely by class action lawyers. Moreover, forfeiture of a potential but belated cause of action is inherent in statutes of repose, which "represent a pervasive legislative judgment [that] the right to be free of stale claims in time comes to prevail over the right to prosecute them." *United States v. Kubrick*, 444 U.S. 111, 117 (1979).

were superior to all of its competitors, but the company's stock went to zero before these misrepresentations were revealed because the automobile was invented, the alleged misrepresentations would not be the cause of that decline. If issuer corporations make misrepresentations, but a stock declines for unrelated reasons prior to any corrective disclosure, there should be no damages for the pre-correction decline. Notwithstanding that result, wrongdoers may still be subject to criminal and administrative penalties and held accountable for their actions.[20]

CONCLUSION

For the foregoing reasons, this Court should reverse the Ninth Circuit decision below with respect to respondents' claims regarding Albuterol Spiros.

Respectfully submitted,

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20. *See* Amicus Br. of Merrill Lynch at 24-30.

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No. 03-932

In the Supreme Court of the United States

DURA PHARMACEUTICALS, INC., ET AL., PETITIONERS

v.

MICHAEL BROUDO, ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONERS

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QUESTION PRESENTED

Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price.

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In the Supreme Court of the United States

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DURA PHARMACEUTICALS, INC., ET AL., PETITIONERS

v.

MICHAEL BROUDO, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONERS

INTEREST OF THE UNITED STATES

The United States, through the Department of Justice (Department) and the Securities and Exchange Commission (Commission), administers and enforces the federal securities laws. The issue in this case is the appropriate standard of loss causation in a private securities-fraud action in which the plaintiff invokes the fraud-on-the-market theory. Private securities-fraud actions are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department and the Commission, and the United States has a strong interest in seeing that the principles applied in such actions promote the purposes of the securities laws. The United States filed a brief at the petition stage of this case at the invitation of the Court.

STATEMENT

1. a. Petitioner Dura Pharmaceuticals, Inc. (Dura) developed and marketed products for the treatment of allergies, asthma, and other respiratory conditions. Pet. App. 2a n.1. In 1995, it began developing an asthma-drug delivery device called Albuterol Spiros. *Id.* at 19a-20a. The following year, it began selling a respiratory antibiotic called Ceclor CD. *Id.* at 41a. In an April 15, 1997, press release announcing better-than-expected results for the first quarter of 1997, Dura stated that "strong progress" had been made in selling Ceclor CD, and that "[p]atient dosing" had been completed for the Albuterol Spiros clinical trials that were necessary before a new drug application (NDA) could be submitted to the Food and Drug Administration (FDA). *Id.* at 3a. Dura filed the NDA for Albuterol Spiros in November 1997. *Id.* at 4a.

On February 24, 1998, Dura announced that, for a number of reasons, including slower than expected sales of Ceclor CD, it was anticipating lower revenues and earnings per share in 1998 than had previously been forecast. The next day, the price of Dura stock dropped to $20 3/4 from $39 1/8, a 47% one-day loss. The February 24 announcement did not mention Albuteros Spiros. Pet. App. 5a, 7a, 40a.

Dura's business declined throughout the remainder of 1998. Pet. App. 5a. In November 1998, Dura announced that the FDA had declined to approve Albuteros Spiros, "due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns." *Ibid.* Although the complaint in this case does not allege any decline in Dura's stock price after the November 1998 disclosure, it is a fact that, following the announcement and well after the end of the class

period, the price of Dura stock dropped from $12 3/8 to $9 3/4. Pet. 3 n.4; Pet. C.A. Supp. E.R. Tab 79, Exh. L. Within 12 trading days, however, the stock was again selling at nearly $12 1/2. *Ibid.*

b. Respondents, shareholders who purchased Dura stock between April 15, 1997, and February 24, 1998, filed several securities-fraud class actions against Dura and a number of its senior officers and directors, who are also petitioners here. After the complaints were consolidated and amended, the district court dismissed the resulting complaint without prejudice. Respondents then filed a second consolidated amended complaint (complaint). It alleged that petitioners made false and misleading statements about Dura's performance during the class period, and thereby violated Section 10(b) of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, as well as Section 20(a) of the 1934 Act, 15 U.S.C. 78t(a), the "controlling person" provision. Pet. App. 2a, 5a-6a, 18a-19a.

According to the complaint, petitioners made misrepresentations concerning a number of different aspects of Dura's business, only two of which are still at issue: sales of Ceclor CD and the development of Albuterol Spiros. Respondents alleged that petitioners deliberately misled the investing public into believing that the sales of Ceclor CD and the prospects for Albuterol Spiros were better than they in fact were. Respondents relied on the fraud-on-the-market theory, see *Basic Inc.* v. *Levinson*, 485 U.S. 224, 241-249 (1988), which establishes a rebuttable presumption that investors rely on a material misrepresentation made to the public. Pet. App. 2a-3a, 6a-7a, 12a, 27a, 34a-39a, 41a-44a; Resp. C.A. E.R. Tab 72, at 85 (¶ 179).

2. The district court granted petitioners' motion to dismiss. Pet. App. 18a-51a. It held that the allegations concerning Ceclor CD did not satisfy the pleading requirements for Rule 10b-5 claims, because they did not adequately demonstrate that the challenged statements were made with scienter. *Id.* at 45a-47a. It held that the allegations concerning Albuterol Spiros failed to state a claim under Rule 10b-5, because they did not satisfy the element of loss causation, which means that "the misrepresentations or omissions caused the harm." *Id.* at 39a-40a (quoting *Binder* v. *Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999), cert. denied, 528 U.S. 1154 (2000)). It held that the "controlling person" allegations must be dismissed, because such a claim requires "a primary violation" that was absent here. *Id.* at 50a. And it ordered that the dismissal be with prejudice, because respondents had already had an opportunity to amend the complaint to satisfy the applicable pleading requirements. *Id.* at 51a.

In holding that the Albuterol Spiros allegations did not satisfy the element of loss causation, the district court reasoned that Dura's announcement on February 24, 1998, did not "contain[] any negative information about Albuterol Spiros"; that "Dura did not announce that the FDA would not approve Albutero! Spiros until nine months later, in November 1998"; and that the complaint therefore "does not contain any allegations that the FDA's non-approval had any relationship to the February price drop." Pet. App. 40a. Rather than having a connection with "the alleged misrepresentations and omissions regarding Albuterol Spiros," the court said, "the decline in Dura's stock price" on February 24 "was the result of an expected revenue shortfall." *Ibid.*

3. The court of appeals reversed and remanded for further proceedings. Pet. App. 1a-17a. With respect to the Ceclor CD allegations, the court of appeals held that, although the district court correctly concluded that each allegation of scienter was insufficient standing alone, it failed to determine whether the allegations were sufficient when considered collectively. *Id.* at 11a-14a. The court also held that, contrary to the conclusion of the district court, the Albuterol Spiros allegations did satisfy the element of loss causation. *Id.* at 8a-11a. And the court held that respondents should have been granted leave to amend the complaint. *Id.* at 15a-16a & n.6. The court declined petitioners' invitation to affirm on alternative grounds not addressed by the district court. *Id.* at 16a.

In holding that respondents had adequately alleged loss causation, the court of appeals noted that that element is satisfied if the plaintiff shows that "the misrepresentation touches upon the reasons for the investment's decline in value." Pet. App. 8a (quoting *Binder*, 184 F.3d at 1066). While acknowledging the ambiguity of the phrase "touches upon," the court followed a prior decision of the Ninth Circuit holding that a plaintiff in a fraud-on-the-market case establishes loss causation if he shows that "the price on the date of purchase was inflated because of the misrepresentation." *Id.* at 9a (quoting *Knapp* v. *Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996), cert. denied, 519 U.S. 1112 (1997)). "[I]t is not necessary," the court said, "that a disclosure and subsequent drop in the market price of the stock have actually occurred," because "the injury occurs at the time of the transaction," which is the time at which "damages are to be measured." *Ibid.* The court thus held that, to satisfy the element of loss causation, a plaintiff need not plead "a stock price drop following a

corrective disclosure or otherwise"; he need only plead "that the price at the time of purchase was overstated and sufficient identification of the cause." *Ibid.* The court concluded that the complaint satisfied this requirement, because it alleged that "the price of the stock was overvalued in part due to the misrepresentations * * * that the development and testing of the Albuterol Spiros device were proceeding satisfactorily and that FDA approval of the device was imminent." *Id.* at 10a-11a.

SUMMARY OF ARGUMENT

The district court correctly dismissed respondents' allegations concerning Albuterol Spiros, because respondents failed to plead loss causation—*i.e.*, a causal connection between the alleged fraud and the investment's subsequent decline in value. The Ninth Circuit's standard, which effectively obviates the need to allege loss causation, rests on a mistaken view of when the injury occurs and cannot be reconciled with provisions of the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737.

A. As part of a broader effort to curtail the abusive practices that undermine the beneficial purposes of private securities litigation, Congress amended the 1934 Act in the PSLRA to codify the requirement that the misrepresentation at issue "caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. 78u-4(b)(4). Congress clarified that a misrepresentation and a loss were not sufficient. To recover, a securities-fraud plaintiff must plead and prove that the alleged misrepresentation caused the alleged loss. This requirement of loss causation, which had previously been a judicially inferred element of a Rule 10b-5 cause of action, is to be distinguished from

transaction causation, which is a separate element. While transaction causation means that the misrepresentation caused the plaintiff to engage in the securities transaction, loss causation means that the misrepresentation caused the plaintiff economic harm. The justification for the loss-causation requirement is that a person induced to invest by a misrepresentation should not be permitted to recover for a decline in value unrelated to the misrepresentation.

B. In the Ninth Circuit, a plaintiff in a fraud-on-the-market case can establish loss causation merely by pleading and proving that he purchased the security at a price inflated by the defendant's misrepresentation. That standard is incorrect. As other circuits have recognized, there is no loss causation in a fraud-on-the-market case unless the truth was subsequently revealed and the inflation attributable to the misrepresentation was thereby removed from the price of the security to the injury of the plaintiff. The truth can be revealed either by a corrective disclosure or by events —for example, the materialization of a risk represented to be absent. The inflation attributable to the untruth will generally be removed through an absolute decline in the price of the security, but could also be removed through an increase in the price that is smaller than it otherwise would have been.

The Ninth Circuit's standard rests on the premise that the loss caused by a misrepresentation occurs at the time of the transaction, when the investor pays "too much" for the security. The premise is mistaken, because an investor can fully recoup his overpayment by reselling the security at the prevailing inflated price, and thus does not suffer *any* loss at the time of the purchase, much less one caused by the misrepresentation. A loss is a decline in value, and in a fraud-on-

the-market case, that necessarily occurs at a point in time *after* the purchase. If it were otherwise, a plaintiff who purchased and then resold at the inflated price would recover a windfall; loss causation would be present in every fraud-on-the-market case in which the presumption of reliance was unrebutted; and there would be no practical difference between loss causation and transaction causation.

The Ninth Circuit's standard is also difficult to reconcile with the loss-causation provision that the PSLRA added to Section 12 of the Securities Act of 1933 (1933 Act), which enables a defendant to defeat liability by showing that the amount recoverable represents "other than the depreciation in value of the * * * security" resulting from the misrepresentation. 15 U.S.C. 77*l*(b). Since there is no reason to believe that Congress had two different standards of loss causation in mind when it enacted the PSLRA, it is reasonable to conclude that Congress meant to require a plaintiff in a Rule 10b-5 case to plead and prove that he was injured by a "depreciation in value of the * * * security" that resulted from the misrepresentation. That is different from paying too much at the time of purchase.

C. The allegations of loss causation in the complaint —that respondents "paid artificially inflated prices for Dura securities," Resp. C.A. E.R. Tab 72, at 85 (¶ 179) —may satisfy the Ninth Circuit's standard, but that standard is incorrect. And the complaint does not allege facts that satisfy the correct standard—*i.e.*, that the inflation attributable to the alleged misrepresentations about Albuterol Spiros was removed from the price before respondents sold their Dura stock. Dismissal of that portion of the complaint was therefore proper.

ARGUMENT

RESPONDENTS' ALLEGATIONS CONCERNING ALBUTEROL SPIROS DO NOT SATISFY THE LOSS-CAUSATION REQUIREMENT OF RULE 10b-5, BECAUSE THE COMPLAINT DOES NOT ALLEGE THAT THE INFLATION IN THE PRICE OF DURA STOCK ATTRIBUTABLE TO THE CHALLENGED MISREPRESENTATIONS WAS ELIMINATED OR REDUCED

Section 10(b) of the 1934 Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security * * * , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j(b). The Commission's Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," to (a) "employ any device, scheme, or artifice to defraud"; (b) "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made * * * not misleading"; or (c) "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5. Section 10(b) has been construed to afford an implied right of action to purchasers or sellers of securities who have been injured by its violation. See, *e.g.*, *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 380 & n.10 (1983); *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

In prior cases, this Court has addressed a number of the elements of a private cause of action under Rule 10b-5. See *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988)

(materiality and reliance); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (scienter); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975) (purchaser or seller). This case involves the element of causation, or at least one component of it: the requirement, now codified, that the misrepresentation alleged to violate Rule 10b-5 "caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. 78u-4(b)(4). As explained below, the loss-causation standard applied by the court of appeals is incorrect, and respondents' allegations do not satisfy the correct standard.

A. A Private Plaintiff Asserting A Violation Of Rule 10b-5 Must Plead And Prove Loss Causation

Between 1974, when the Second Circuit first adopted the "loss causation" terminology in *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, cert. denied, 421 U.S. 976 (1975), and 1995, when Congress passed the PSLRA, loss causation was generally recognized as a judicially inferred element of a Rule 10b-5 cause of action. The PSLRA codified the loss-causation requirement, making it a statutory element.

1. *Loss causation was initially a judicially inferred element of a Rule 10b-5 cause of action*

Rule 10b-5 is "distinct from common-law deceit and misrepresentation," and indeed was "in part designed to add to the protections provided investors by the common law." *Basic Inc.*, 485 U.S. at 244 n.22 (citing *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. at 744-745, and *Herman & MacLean* v. *Huddleston*, 459 U.S. at 388-389). Courts have often been guided by "common-law doctrines of fraud and deceit," however, in deciding what elements a Rule 10b-5 cause of action comprises, and what must be pleaded and proved to establish them. *Id.* at 253 (opinion of White, J.). That is

certainly true of loss causation. As Judge Posner has observed, "what securities lawyers call 'loss causation' *is* the standard common law fraud rule * * *, merely borrowed for use in federal securities fraud cases." *Bastian* v. *Petren Res. Corp.*, 892 F.2d 680, 683 (7th Cir.), cert. denied, 496 U.S. 906 (1990). See Restatement (Second) of Torts § 548A & cmt. b (1977) (Restatement of Torts) (stating loss-causation requirement).

The securities-fraud cases draw a distinction between loss causation and transaction causation. The latter means that the misrepresentation "caused the [plaintiff] to engage in the transaction in question," while the former means that the misrepresentation "caused the economic harm." *Schlick*, 507 F.2d at 380. Transaction causation has been viewed as a synonym for the element of reliance, *e.g.*, *Harris* v. *Union Elec. Co.*, 787 F.2d 355, 366 (8th Cir.), cert. denied, 479 U.S. 823 (1986); *Schlick*, 507 F.2d at 380, and as an analogue of the tort-law concept of "but-for causation" or "causation in fact," *e.g.*, *Chemical Bank* v. *Arthur Anderson & Co.*, 726 F.2d 930, 943 n.23 (2d Cir.) (Friendly, J.), cert. denied, 469 U.S. 884 (1984); *Wilson* v. *Comtech Telecom. Corp.*, 648 F.2d 88, 92 & n.7 (2d Cir. 1981), in the sense that, but for the initial transaction, there would be no injury. Loss causation has been viewed as a synonym for the element of causation generally, *Bastian*, 892 F.2d at 686, and as an analogue of the tort-law concept of "proximate causation" or "legal causation," *e.g.*, *Marbury Mgmt., Inc.* v. *Kohn*, 629 F.2d 705, 708 (2d Cir.), cert. denied, 449 U.S. 1011 (1980), in the sense that the actual loss suffered by the investor must flow from the misrepresentation itself rather than from unrelated circumstances.

To prevail on a Rule 10b-5 claim, a plaintiff must make "a showing of both loss causation * * * and transaction causation." *Wilson* v. *Comtech Telecom. Corp.*, 648 F.2d at 92 n.7 (quoting *Schlick*, 507 F.2d at 380). As the Fifth Circuit put it in one of the most widely cited cases on the subject, "[t]he plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss." *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549 (1981), rev'd in part on other grounds, 459 U.S. 375 (1983). Accord, *e.g.*, *Marbury Mgmt.*, 629 F.2d at 720 (Meskill, J., dissenting) ("the violation must have precipitated the securities decision" and "the victim's injury must also be proven to have derived from that same securities decision"). In other words, it is not enough to allege a misrepresentation and a loss on the sale of the security; the plaintiff must also establish that his loss was caused by the misrepresentation.

The loss-causation requirement "is intended to 'fix a legal limit on a person's responsibility, even for wrongful acts.'" *Castellano* v. *Young & Rubicam, Inc.*, 257 F.3d 171, 187 (2d Cir. 2001) (quoting *First Nationwide Bank* v. *Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994), cert. denied, 513 U.S. 1079 (1995)). Its justification is that a person induced to invest on false pretenses should not be able to recover when the value of the investment declines for reasons unrelated to the misrepresentation—for example, because of a recession. If the law were otherwise, "Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission." *Huddleston*, 640 F.2d at 549. As Judge Posner has explained, "[n]o social purpose would be served by encouraging everyone who suffers an investment loss

because of an unanticipated change in market conditions" to scrutinize offering memoranda "in the hope of uncovering a misrepresentation." *Bastian*, 892 F.2d at 685.

2. *Loss causation is now a statutory element of a Rule 10b-5 cause of action*

As Congress recognized in enacting the PSLRA, meritorious private securities litigation serves a number of beneficial purposes. It enables "defrauded investors [to] recover their losses without having to rely upon government action," it promotes "public and global confidence in our capital markets," and it helps "deter wrongdoing." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995). The PSLRA was prompted by "significant evidence" that these salutary purposes were being "undermined by * * * abusive and meritless suits." *Ibid.* The abusive practices of which Congress heard evidence included "the routine filing of lawsuits against issuers of securities * * * whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only a faint hope that the discovery process might lead eventually to some plausible cause of action." *Ibid.* The legislative history noted that "innocent parties are often forced to pay exorbitant 'settlements'" to terminate such litigation, with the result that "the issuer's own investors * * * are the ultimate losers." *Id.* at 32. The intent of the PSLRA was "to lower the cost of raising capital by combatting these abuses, while maintaining the incentive for bringing meritorious actions." S. Rep. No. 98, 104th Cong., 2d Sess. 4 (1995). Congress sought to effectuate that intent by making a number of substantive and procedural changes to the securities laws.

The legislative history identifies three specific purposes of the PSLRA, and lists the provisions enacted to further each purpose. S. Rep. No. 98, *supra*, at 5-7. First, to "encourage the voluntary disclosure of information by issuers," the PSLRA created a "safe harbor" for forward-looking statements. *Id.* at 5-6. See 15 U.S.C. 77z-2, 78u-5. Second, to "empower investors so that they, not their lawyers, control securities litigation," the PSLRA made a number of changes to class-action procedures. S. Rep. No. 98, *supra*, at 6. See 15 U.S.C. 77z-1(a), 78u-4(a). Third, to "encourage plaintiffs' lawyers to pursue valid claims for securities fraud and to encourage defendants to fight abusive claims," the PSLRA adopted a modified proportionate liability standard, clarified certain of the pleading requirements for securities-fraud complaints, and required courts to make findings concerning compliance with Rule 11 of the Federal Rules of Civil Procedure. S. Rep. No. 98, *supra*, at 6-7. See 15 U.S.C. 77z-1(c), 78u-4(b)(1) and (2), (c), and (f).

The legislative history also identifies other provisions of the PSLRA that were "intended to reduce the cost of raising capital." S. Rep. No. 98, *supra*, at 7. One of them "codif[ied] the requirement under current law that plaintiffs prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors." *Ibid.* That provision was added to the 1934 Act as Section 21D(b)(4), and is titled "Loss causation." 15 U.S.C. 78u-4(b)(4). It provides that, "[i]n any private action arising under [the 1934 Act], the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate [the 1934 Act] caused the loss for which the plaintiff seeks to recover damages." *Ibid.* Because loss causation is an element of the plaintiff's affirmative case, a complaint

must contain allegations that establish the element either directly or inferentially. See 5 Charles A. Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1216, at 156-159 & n.21 (2d ed. 1990). And because loss causation is an element of a fraud cause of action, the allegations must be "stated with particularity," Fed. R. Civ. P. 9(b), and must satisfy the pleading requirements added to the 1934 Act by the PSLRA, see 15 U.S.C. 78u-4(b)(1) and (2).

B. To Establish Loss Causation In A Fraud-On-The-Market Case, A Plaintiff Must Plead And Prove That The Inflation In The Price Of The Security Attributable To The Misrepresentation Was Eliminated Or Reduced

Basic Inc. v. *Levinson* recognizes that reliance is an element of a Rule 10b-5 cause of action, 485 U.S. at 243, but holds that, where the alleged fraud involves a security traded on an open and developed securities market, an investor's "reliance on any public material misrepresentations * * * may be presumed for purposes of a Rule 10b-5 action," *id.* at 247, subject to rebuttal by the defendant, *id.* at 248-249. The premise of the fraud-on-the-market theory is that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations," *id.* at 246, and that "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price," *id.* at 247. The court of appeals held that, in order to establish loss causation in a Rule 10b-5 case alleging fraud on the market, a plaintiff need only "show[] that the price on the date of purchase was inflated because of the misrepresentation." Pet. App. 9a (quoting *Knapp* v. *Ernst & Whinney*, 90 F.3d 1431,

1438 (9th Cir. 1996), cert. denied, 519 U.S. 1112 (1997)). That standard is incorrect. As other courts have held, a plaintiff cannot establish loss causation in a fraud-on-the-market case unless he pleads and proves that he suffered actual injury from the misrepresentation, in that the truth was revealed (at least in part) and the inflation in the price of the security attributable to the misrepresentation was thereby eliminated (or reduced) to the plaintiff's detriment.[1]

1. ***The Ninth Circuit's loss-causation standard has been rejected by other courts and is inconsistent with the common law***

a. In *Robbins* v. *Koger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997), the defendant company employed improper accounting practices that overstated its cash flow, with the result that it was able to pay higher dividends, which in turn increased the price of its stock. The company later cut its dividend because of a decrease in available financing, and the stock price dropped as a result. The improper accounting practices were not disclosed until more than a year after the dividend was cut. A class of plaintiffs who had purchased stock between the time cash flow was overstated and the time the dividend was cut sued the company under Rule 10b-5, alleging that they had been misled into purchasing stock by the false statements concerning cash flow in the company's financial statements. A jury returned a verdict for the plaintiffs. *Id.* at 1443-1446.

The Eleventh Circuit reversed, finding the evidence of loss causation insufficient as a matter of law. Assuming without deciding that there was sufficient evidence that the misrepresentation "artificially inflated the price of [the company's] stock," the court held, in acknowledged disagreement with the Ninth Circuit's decision in *Knapp*, that "proof that a plaintiff purchased securities at an artificially inflated price, without more, [does not] satisf[y] the loss causation requirement." *Robbins*, 116 F.3d at 1447-1448. Concluding that there was nothing more in the case before it, the court held that loss causation had not been proved because there was "no evidence that th[e] price inflation was removed from the market price of [the] stock, causing [the] plaintiffs a loss." *Id.* at 1448. Uncontradicted evidence, the court explained, showed that the dividend was cut because the company was concerned that future financing would be unavailable, not because it "discovered [and then disclosed] that past accounting errors had overstated its cash flow." *Ibid.*

In *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000), cert. denied, 531 U.S. 1149 (2001), the defendant company (Cendant) made false statements about its financial condition in connection with a tender offer for shares of another company (ABI), which had the effect of increasing the price of ABI stock. When the misrepresentations were disclosed, the price of ABI stock fell. Shareholders who had purchased ABI stock between the date of the tender offer and the date of the disclosure then filed a class action against Cendant under Rule 10b-5. The district court dismissed the suit, finding (among other things) that the complaint did not adequately plead loss causation. *Id.* at 169-172.

The Third Circuit reversed. Following the Eleventh Circuit's decision in *Robbins*, the court held that, even when a security is purchased "at a price that is inflated due to an alleged misrepresentation," loss causation is

[1] Loss causation and damages are separate elements. This brief does not address all of the factors that may be relevant to the calculation of damages in a fraud-on-the-market case.

established only if the value of the security "actually decline[s] as a result of [the] alleged misrepresentation." *Semerenko*, 223 F.3d at 184-185. The court determined that the complaint met that standard, because it alleged that the class "purchased shares of ABI common stock at a price that was inflated due to the alleged misrepresentations" *and* that it "suffered a loss when the truth was made known and the price of ABI common stock returned to its true value." *Id.* at 185.

The "loss causation" standard applied by the Third and Eleventh Circuits in these Rule 10b-5 cases is identical to the "legal causation" standard set forth in the Second Restatement of Torts for common law fraud in the sale of securities. In the portion of the Restatement that covers the tort of fraudulent misrepresentation, in the commentary to the section titled "Legal Causation of Pecuniary Loss," the Restatement says that

> one who misrepresents the financial condition of a corporation in order to sell its stock will become liable to a purchaser who relies upon the misinformation for the loss that he sustains *when the facts as to the finances of the corporation become generally known and as a result the value of the shares is depreciated on the market.*

Restatement of Torts § 548A cmt. b (emphasis added). The Restatement contrasts this situation with one in which "the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition." *Ibid.* In a circumstance of that type—one, for example, in which the value of the stock goes down "because of the sudden death of the corporation's leading officers"—there is "no liability." *Ibid.* See also

W. Page Keeton et al., *Prosser and Keeton on the Law of Torts* § 110, at 767 (5th ed. 1984) (*Prosser and Keeton on Torts*) ("[I]f false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors [that] in no way relate to the representation[,] will not afford any basis for recovery."). As the Restatement explains, "[a]lthough the misrepresentation [in such a case] has in fact caused the loss," in the sense that "it has induced the purchase without which the loss would not have occurred," the misrepresentation "is not a legal cause of the loss for which the maker is responsible." Restatement of Torts § 548A cmt. b.[2]

b. The typical case in which the truth is revealed and the inflation attributable to a misrepresentation is removed from the price of stock is one in which the company makes a corrective disclosure—through a press release, for example, or a public filing—that is followed by a drop in the price. *Semerenko* is such a case. But the fraud can be revealed by means other than a corrective disclosure, and a drop in the stock price may not be a necessary condition for establishing loss causation in every fraud on-the-market case. To the extent that courts or litigants have suggested otherwise, they are mistaken.

First, inflation attributable to a misrepresentation might be reduced or eliminated even if there were a net *increase* in price. That could happen if the company

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[2] In cases decided both before and after the enactment of the PSLRA, the Second Circuit has relied on this section of the Restatement in describing the loss-causation element of a Rule 10b-5 cause of action. See *AUSA Life Ins. Co.* v. *Ernst & Young*, 206 F.3d 202, 219-220 (2000); *Citibank, N.A.* v. *K-H Corp.*, 968 F.2d 1489, 1496 (1992); *Marbury Mgmt.*, 629 F.2d at 708.

corrected the false information and at the same time issued unrelated positive information. Thus, while it is ordinarily a decline in the price of stock that harms investors, they can also suffer injury "[i]f a stock does not appreciate as it would have absent the fraudulent conduct," *Gebhardt* v. *ConAgra Foods, Inc.*, 335 F.3d 824, 831-832 (8th Cir. 2003), so that their profit is smaller than it would otherwise have been. As Judge Easterbrook has observed, "a firm that lies about some assets cannot defeat liability by showing that other parts of its business did better than expected, counterbalancing the loss." *Goldberg* v. *Household Bank*, 890 F.2d 965, 966 (7th Cir. 1989).

Second, the inflation in the price of a security attributable to a misrepresentation might be reduced or eliminated even if the company does not make a public statement that discloses the true state of affairs. The truth can be revealed by events rather than words. If, for example, the misrepresentation is that the financial condition of the company is such that it would be immune from a particular downturn in the economy, and if there is then such a downturn and the company is affected, those events will reveal to the public that the representation was untrue. See Restatement of Torts § 548A cmt. b. A number of court of appeals decisions recognize that loss causation can be established in circumstances of this type (although they are not fraud-on-the-market cases). See, *e.g.*, *Emergent Capital Inv. Mgmt., LLC* v. *Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003) (defendants "concealed [facts that] reflected [an] executive's inability to manage debt and maintain adequate liquidity," and plaintiffs' investment "became worthless because of the company's liquidity crisis," which plaintiffs attributed to "the executive's inability to manage the company's finances"); *Bastian*,

892 F.2d at 685 ("a broker gives false assurances to his customer that an investment is risk-free," but "[i]n fact it is risky, the risk materializes, [and] the investment is lost"). Cf. *Prosser and Keeton on Torts* § 110, at 767 ("the plaintiff stores his goods in a warehouse represented * * * to be fireproof and they are destroyed when it burns down").

2. *The Ninth Circuit's loss-causation standard is incorrect*

a. The Ninth Circuit does not require a plaintiff in a fraud-on-the-market case to plead or prove that he suffered actual injury from the misrepresentation, in that the inflation in the price of the security attributable to the defendant's misrepresentation was eliminated or reduced when the truth was revealed. Under its view of loss causation, an investor's loss "occurs at the time of the transaction," when he is harmed by paying too much, and a causal connection exists because it is the misrepresentation that inflated the price. Pet. App. 9a. That view is mistaken. "[A] purchase-time value disparity, standing alone, cannot satisfy the loss causation pleading requirement." *Emergent Capital*, 343 F.3d at 198.

A necessary corollary of the fraud-on-the-market theory is that the inflation associated with an alleged misrepresentation will be incorporated into the value of a security, not only at the time of purchase, but until the truth is disclosed. See *Semerenko*, 223 F.3d at 185. An investor will therefore be able to recoup his "overpayment" by reselling the security at the inflated price before the misrepresentation is corrected. See *ibid.* For that reason, it cannot be said that a plaintiff in a fraud-on-the-market case who purchases a security at an inflated price has suffered *any* loss at the time of

purchase, much less one caused by the defendant's misrepresentation. See *ibid.*; *Robbins*, 116 F.3d at 1448. And even if the security's price declines after the purchase for reasons unrelated to the fraud, the investor has still suffered no loss *caused by the fraud* and thus has no right to recovery. See *Huddleston*, 640 F.2d at 549 n.25.

It might be argued that the possibility of recoupment does not alter the fact that an investor who pays too much for a security suffers a loss by virtue of the overpayment. Such an argument would be without merit. "Loss" means a decline in value of the security, and in a fraud-in-the-market case, that necessarily occurs at some point *after* the security has been purchased.

Determining loss at the time of purchase would grant a windfall to investors who sold before the reduction or elimination of the artificial inflation, because they would recover the portion of the purchase price attributable to the fraud on resale, and then, under the Ninth Circuit's logic, would be entitled to recover that same amount again as damages for the loss. If, on the other hand, damages would not be recoverable in such a case, as respondents contend (Supp. Br. 1-3), the Ninth Circuit's standard would lead to the bizarre result that a plaintiff could establish both loss and loss causation but be categorically disentitled to any damages for the loss. Respondents' concession that there could be no recovery is necessitated by the reality that a plaintiff in such a case has suffered no injury from the "overpayment," because, by virtue of the resale before the value of the security is corrected, the overpayment remains only theoretical. The possibility of resale without injury underscores that loss causation occurs when the inflated value of the security is corrected, not at the moment of purchase.

Adopting the Ninth Circuit's standard would also mean that loss causation is present in every fraud-on-the-market case in which the presumption of reliance is unrebutted. That is because, under the Ninth Circuit's view, loss causation is satisfied when the misrepresentation increased the purchase price, and the fraud-on-the-market theory itself provides the causal connection between the price of a security and a material misrepresentation. A fundamental premise of the fraud-on-the-market theory is that a material misrepresentation "typically affects the price of the stock," *Peil* v. *Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986) (quoted in *Basic Inc.*, 485 U.S. at 244), and the theory therefore presumes a connection not only between the misrepresentation and the investor's "decision to trade," but also between the misrepresentation and "the price * * * paid" for the security, *Basic Inc.*, 485 U.S. at 248. It would make little sense for Congress to have imposed on plaintiffs the "burden of proving" that the misrepresentation "caused the loss," 15 U.S.C. 78u-4(b)(4), if such causation were necessarily present in every fraud-on-the-market case in which reliance is established. And since the abusive lawsuits that prompted enactment of the PSLRA were typically class actions, a type of suit that invokes the fraud-on-the-market theory, it is not likely that Congress had in mind cases involving "face-to-face transactions," *Basic Inc.*, 485 U.S. at 243-244, when it codified the loss-causation requirement.

In this respect, the Ninth Circuit's standard renders loss causation effectively indistinguishable from transaction causation, as both the Second Circuit and the Eleventh Circuit have observed, see *Emergent Capital*, 343 F.3d at 198; *Robbins*, 116 F.3d at 1448, because, in the Ninth Circuit, proof that the plaintiff purchased stock in a well-developed market after the defendant

made a material misrepresentation will establish the two elements simultaneously (assuming the presumption of reliance is unrebutted). Such a result is difficult to reconcile with the well-established principle that "[l]oss causation is a separate element from transaction causation." *AUSA Life Ins. Co.* v. *Ernst & Young*, 206 F.3d 202, 216 (2d Cir. 2000). Accord, *e.g.*, *Huddleston*, 640 F.2d at 549 n.24; *Schlick*, 507 F.2d at 380.

More fundamentally, the decision below is difficult to reconcile with the very *idea* of loss causation, which is that a plaintiff has no right to recover merely because he purchased a security on false pretenses. Suppose, for example, that an investor bought stock in a company that falsely claimed to be insured; the company acquired insurance a week later, before any of its assets were damaged (*i.e.*, before the misrepresented risk materialized); the company performed well, causing the price of its stock to increase; and the investor then sold the stock at a profit. Under the Ninth Circuit's standard, the investor would be able to demonstrate loss causation. Under the correct standard, there would be no loss at all, much less loss that could be attributed to the misrepresentation.

b. In addition to placing a loss-causation provision in the 1934 Act, the PSLRA placed one in Section 12 of the 1933 Act, 15 U.S.C. 77*l*(b). Beyond the flaws already identified, interpreting the provision in the 1934 Act as the Ninth Circuit does is difficult to reconcile with the language in the 1933 Act.

While the 1934 Act codifies the rule that loss causation is an element that the plaintiff must establish in order to recover on his claim, Section 12 of the 1933 Act makes the *absence* of loss causation an affirmative defense that can limit or preclude a plaintiff's recovery. Subsection (a)(2) of Section 12 prohibits certain misrepresentations "by means of a prospectus or oral communication." 15 U.S.C. 77*l*(a)(2). Subsection (b), like the provision in the 1934 Act, is titled "Loss causation." 15 U.S.C. 77*l*(b). It provides that, if the defendant proves that the amount recoverable under subsection (a)(2), or a portion of it, "represents other than the depreciation in value of the subject security resulting from [the misrepresentation] in the prospectus or oral communication" at issue, then that amount, or portion of it, "shall not be recoverable." *Ibid.*

There is no reason to suppose that, in enacting the PSLRA, Congress intended that (apart from the burden of proof) the concept of loss causation would have different meanings in the 1933 Act and the 1934 Act.[3] It is therefore reasonable to conclude that, in the loss-causation provision the PSLRA added to the 1934 Act, Congress intended the general requirement that the

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[3] The PSLRA's legislative history notes that some courts had held that a plaintiff suing under Section 12 "need not prove that the misstatement or omission caused the loss." S. Rep. No. 98, *supra*, at 23. Congress was concerned that that interpretation "put [issuers] in the position of insuring shareholders and purchasers against normal market risk" and "provide[d] an unfair windfall to shareholders who ha[d] not in any way been harmed by the misstatement or omission." *Ibid.* For example, a plaintiff would be able to recover under that interpretation of Section 12 if a company "fail[ed] to state in a public offering prospectus that it conducts business in a foreign country," the company's "foreign business [was] highly profitable," but its "overall profits decline[d] as the result of unrelated factors (such as a downturn in its domestic business)." *Ibid.* Congress therefore amended Section 12 to "clarify that defendants may raise the absence of 'loss causation' as an affirmative defense." *Ibid.* The loss-causation provision "is modeled after Section 11 of the Securities Act [of 1933], which provides for a similar affirmative defense," *ibid.*, and contains essentially identical language, see 15 U.S.C. 77k(e).

misrepresentation "caused the loss for which the plaintiff seeks to recover damages," 15 U.S.C. 78u-4(b)(4), to mean that a plaintiff must plead and prove the converse of what the defendant must prove under the 1933 Act—namely, that the plaintiff was injured by a "depreciation in value of the subject security resulting from" the misrepresentation at issue. Since the value of a security obviously has not depreciated at the time of purchase, this requirement is not consistent with the Ninth Circuit's standard, under which loss causation can be established at that time. See Pet. App. 9a. Instead, requiring a "depreciation in value of [a] security resulting from" a misrepresentation appears to be another way of saying that the inflation attributable to the misrepresentation must have been eliminated or reduced.

c. Though it was not relied upon by the court below, there is arguably some support for the Ninth Circuit's standard in the legislative history of the PSLRA. The section of the Conference Report that discusses the applicable loss-causation provision reads, in its entirety, as follows:

> The Conference Committee also requires the plaintiff to plead and then to prove that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff in new Section 21D(b)(4) of the 1934 Act. For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.

H.R. Conf. Rep. No. 369, *supra*, at 41. The Senate Report contains similar language:

> The Committee also requires the plaintiff to show that the misstatement or loss alleged in the complaint caused the loss incurred by the plaintiff. For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.

S. Rep. No. 98, *supra*, at 15.

The "example" provided in the Reports, if construed to be an exhaustive description of the plaintiff's burden even in the fraud-on-the-market context, would be essentially identical to the Ninth Circuit's standard. But these brief passages in the Reports do not elaborate on the "example" they provide or explain whether additional proof would be required. For these reasons, and because of the defects in the Ninth Circuit's standard identified above, it is not likely that this isolated, unelaborated example in the Committee Reports reflects a considered congressional judgment as to the standard for establishing loss causation in a Rule 10b-5 case. A contrary conclusion would be particularly unwarranted in light of the statement in a different portion of the same Senate Report that the loss-causation provision of the 1934 Act "codif[ies] the requirement under current law that plaintiffs prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors." S. Rep. No. 98, *supra*, at 7. That language cannot be reconciled with the Ninth Circuit's approach, because, under the latter, a plaintiff who purchased stock at a price inflated by a misrepresentation can establish loss causation even if the subsequent loss in value was caused by factors unrelated to the misrepresentation—and, indeed, even if there was no loss in value at all.

C. The Complaint Does Not Allege That The Inflation In The Price Of Dura Stock Attributable To The Alleged Misrepresentations About Albuterol Spiros Was Eliminated Or Reduced

The loss-causation allegation in the complaint is that respondents "were damaged" because, "[i]n reliance on the integrity of the market, they paid artificially inflated prices for Dura securities." Resp. C.A. E.R. Tab 72, at 85 (¶ 179). This allegation may satisfy the Ninth Circuit's standard, see Resp. C.A. Br. 18 (arguing that it does); Mem. of Points and Authorities in Opp. to Mot. to Dismiss 40 (same), but, for the reasons set forth above, that standard is erroneous. And respondents' loss-causation allegation does not satisfy the correct standard, which requires that respondents allege actual injury from the misrepresentations, in that the inflation in the price of Dura stock attributable to the alleged misstatements concerning Albuterol Spiros was eliminated or reduced when the truth was revealed (by, for example, a disclosure correcting the misstatements).

Nor do respondents allege elsewhere in the complaint that the inflation was removed. Insofar as the complaint says anything about a corrective disclosure followed by a decline in the stock price, for example, the allegations relate to the announcement about Ceclor CD in early 1998, see Resp. C.A. E.R. Tab 72, at 17 (¶ 32), 61-62 (¶ 134), not to the one about Albuterol Spiros several months later. At the time of the former disclosure, the true facts concerning Albuterol Spiros were still unknown to the public, and the price of Dura stock was still artificially inflated (according to respondents' theory) due to the earlier announcements about the device.

The district court was therefore correct in holding that respondents' allegations concerning Albuterol

Spiros do not state a claim for relief under Rule 10b-5. Whether respondents can amend the complaint to satisfy the correct loss-causation standard, and, if they can, whether they should be permitted to do so, are questions to be addressed on remand in the event that they seek leave to amend for that purpose.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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DURA PHARMACEUTICALS, INC. *et al.*,

Petitioners,

v.

MICHAEL BROUDO, *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICUS CURIAE*[1]

For more than 100 years, the American Institute of Certified Public Accountants (AICPA) has served as the national organization of the certified public accounting profession. The AICPA's nearly 340,000 members, all of whom are certified public accountants, provide accounting services to companies and individuals through firms of all sizes, as solo practitioners, and as employees of companies, government, and academia. Among the AICPA's most important roles is to promote and maintain high professional standards among its members. To this end, the Institute has been a principal force in developing accounting and auditing standards, drafting model legislation, sponsoring educational programs, and issuing professional publications to improve the quality of the services provided by CPAs.

The AICPA also has a strong interest in judicial decisions affecting the scope and bases of accountants' liability under the federal securities laws. To that end, the AICPA has participated as *amicus curiae* in a wide variety of cases, including this Court's most significant securities fraud cases in each of the last three decades: *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver*, 511 U.S. 164 (1995); *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988); and *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

The present case, this Court's first foray into the issue of loss causation under the Private Securities Litigation Reform Act of 1995, is of paramount importance to the accounting profession. Loss causation is an indispensable element of the private action available under Section 10(b) of the Securities Exchange Act of 1934, one that helps to separate cases involving genuine injury from those in which disappointed

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[1] The parties' letters of consent to the filing of this brief have been lodged with the Clerk. Pursuant to Rule 37.6 of the Rules of this Court, the AICPA states that no counsel for a party has authored this brief in whole or in part and that no person or entity, other than *amicus curiae*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief.

investors seek to blame others for the consequences of ordinary market risk. If deployed in the misguided fashion endorsed by the Ninth Circuit, loss causation ceases to protect secondary actors, such as auditors of financial statements, against assuming the role of insurers for investment losses not meaningfully linked to their own actions. It is to highlight both the flaws in the Ninth Circuit's analysis and the serious practical significance of this issue for the hundreds of thousands of certified public accountants nationwide that the AICPA respectfully submits this *amicus* brief.

SUMMARY OF ARGUMENT

The federal securities laws are at once important tools for protecting investors against fraud and potentially dangerous vehicles for coercing unfair settlements from innocent defendants. In 1995, concerned that the balance had tipped too far in favor of vexatious litigation, Congress enacted the Private Securities Litigation Reform Act (PSLRA), which significantly tightened the pleading requirements for securities fraud class actions. Among the most important aspects of the PSLRA was the codification of the judge-made loss causation requirement.

This case presents an important and recurring question regarding that requirement: whether, in a case involving a fraud-on-the-market presumption of reliance, plaintiffs can establish the element of loss causation merely by pleading and proving that a defendant's misrepresentations artificially elevated the price of a security, or whether plaintiffs must further plead and prove that the alleged fraud actually caused a subsequent decline in the value of the investment. In adopting the former position, the Ninth Circuit fundamentally misconstrued the nature and purpose of loss causation as it has now been codified by Congress. The court's decision effectively nullifies loss causation as an independent element of a private cause of action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, and contravenes the plain language of the PSLRA.

In so doing, the court of appeals failed to appreciate the important function that loss causation plays in securities fraud litigation. The loss causation element separates genuine fraud cases from those in which disappointed purchasers are simply looking to recover against a deep pocket defendant whose actions are not meaningfully related to the gravamen of the claim. In the latter circumstances, certified public accountants – often the only solvent defendants left in the wake of a corporate collapse – frequently become the deep pockets of choice. The judgement-oriented standards of the auditing process – together with often misguided expectations about what an audit is intended to accomplish – make it all too tempting to bring CPAs into securities fraud class actions. And, given the realities of such litigation, it can be all too difficult and too costly for them to get out.

In order to preserve the balance that Congress intended, it is therefore essential to ensure that the PSLRA's overriding goal of distinguishing genuine securities fraud claims from bogus ones not be compromised. By failing to take loss causation seriously, the decision below ignores Congress' design and subjects auditors (and other secondary actors, including lawyers and market analysts) to strike suits based on statements that played no role in bringing about the investment loss that plaintiffs suffered. The decision below thereby casts CPAs in a role they were never supposed to play: insuring disappointed investors against losses caused by the actions of others or by the ordinary vicissitudes of the market.

ARGUMENT

I. CONGRESS CODIFIED THE LOSS CAUSATION REQUIREMENT IN THE PSLRA TO HELP CURB VEXATIOUS PRIVATE SECURITIES CLASS ACTIONS AGAINST ACCOUNTING FIRMS AND OTHERS

Although private securities suits play an important role in regulating the securities markets and compensating defrauded investors, the abusive potential of such litigation, particularly

class actions, has long been acknowledged. "There has been a widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 743, 739 (1975). Plaintiffs in such cases have found that defendants – especially secondary actors like accounting firms – can often be compelled, "as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver*, 511 U.S. 164, 189 (1995). Strike suits have been a perpetual concern for financial service professionals because "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of proportion to its prospect of success at trial * * *." *Blue Chip Stamps*, 421 U.S. at 740.

The problem of vexatious 10b-5 class actions became especially acute in the late 1980s and early 1990s, a time when private securities litigation had become more frequent and more costly. To address what majorities in both political parties had come to see as a system "seriously out of balance," Congress enacted the PSLRA in 1995. Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995, Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAWYER 1009, 1009 (1996). The statute codified the private right of action for securities fraud and imposed important restrictions on its use. Its chief purpose was to curb abusive practices in private securities litigation:

> [T]he evils flowing from abusive securities litigation start with the filing of the complaint and continue through to the final disposition of the action. A complaint alleging violations of the Federal securities laws is easy to craft and can be filed with little or no due diligence. A drop in a public company's stock price, a failed product development project, or even unpredictable adverse market conditions

> that affect earnings results for a quarter can trigger numerous securities fraud lawsuits against a company.

S. Rep. 104-98, at 8 (June 19, 1995). Of particular concern was the use of frivolous lawsuits to coerce defendants to settle in order to avoid the exorbitant costs of litigation. See *Behlen* v. *Merrill Lynch*, 311 F.3d 1087, 1090-91 (11th Cir. 2002) (citing H.R. Rep. No. 104-369, at 31 (Nov. 28, 1995)); *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 191 (1st Cir. 1999) ("The enactment of the PSLRA in 1995 marked a bipartisan effort to curb abuse in private securities lawsuits, particularly the filing of strike suits.").

Certified public accountants proved particularly vulnerable to this onslaught. Although CPAs perform a variety of services for their clients, they face litigation most frequently in connection with their role as auditors of public companies' financial statements. See John Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1931 (1988). In the typical case, plaintiffs claim that the auditor's unqualified opinion on the company's financial statements induced them to invest.

Allegations of this kind in the early 1990s saddled the largest accounting firms with litigation expenses of more than three-quarters of a billion dollars and exposed them to potential liability in the untold billions. Indeed, one major firm, Laventhol & Horwath, failed as a result. See John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 BOSTON U. L. REV. 301, 318 n.51 (2004). As this Court has observed, "[l]itigation under 10b-5 * * * requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." *Central Bank of Denver*, 511 U.S. at 189 (noting statements in the congressional record that in 83% of 10b-5 cases major accounting firms pay $8 in legal fees for every $1 paid in claims). Congress took careful note of these trends when it passed the PSLRA. See S. Rep. 104-98, at 21 ("Accounting firms particularly have been hard hit by securities litigation."); see also *ibid.* (noting that

when "peripheral defendants are sued, the pressure to settle is overwhelming – regardless of the defendant's culpability").

To help protect against these dangers, the PSLRA imposed a "strong pleading requirement" for 10b-5 actions, which included the express codification of the loss causation requirement. S. Rep. 104-98, at 15; see generally Phillips & Miller, 51 BUS. LAWYER at 1018-29 (describing the harmful effects of class action securities litigation that led Congress to enact the PSLRA). Section 21D(b)(4) of the Act thus provides that "[i]n any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). As we explain below, however, the Ninth Circuit's decision in this case fails to take this requirement seriously as an independent element of Rule 10b-5. Moreover, by allowing plaintiffs to satisfy loss causation even where they cannot meaningfully connect the alleged fraud with any economic injury that they have suffered, that decision significantly undermines the PSLRA's goal of reducing vexatious securities fraud litigation.

II. THE NINTH CIRCUIT'S UNDERSTANDING OF LOSS CAUSATION IS INCONSISTENT WITH THE PSLRA

Although the PSLRA has been law for nearly a decade, few courts have paid serious attention to the statute in applying the loss causation requirement. The Ninth Circuit's opinion in this case is a perfect example; in discussing loss causation, the court never mentions the PSLRA, choosing rather to focus on cases that either ignore the statute or were decided before it was enacted. See Pet. App. 8a-9a (citing *Knapp* v. *Ernst & Whitney*, 90 F.3d 1431, 1437-38 (9th Cir. 1996); *McGonigle* v. *Combs*, 968 F.2d 810 (9th Cir. 1992)). This omission is unfortunate, as a careful analysis of the statute confirms that the approach adopted by the court of appeals is indefensible, for at least two independent reasons.

A. The "lookback" provision of the PSLRA confirms that loss causation cannot consist merely of purchase-time inflation

First, the Ninth Circuit's understanding of loss causation is inconsistent with the so-called "lookback" provision, which limits damages in 10b-5 actions in which, as here, "the plaintiff seeks to establish damages by reference to the market price of a security." 15 U.S.C. § 78u-4(e)(1). In such cases

> the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

Ibid. This provision makes clear that damages in a securities fraud case such as this one do not accrue at the time of the purchase, but instead are measured based upon fluctuations in the price of the security that accompany a corrective disclosure.[2] In turn, it is clear from the PSLRA's loss causation provision (Section 21D(b)(4)) that a plaintiff's "loss" necessarily derives from the same source as damages. See 15 U.S.C. § 78u-4(b)(4) (requiring the plaintiff to show that the fraud "caused the *loss* for which the plaintiff seeks to recover *damages*") (emphases added).

The PSLRA thus expressly hitches damages to post-transaction fluctuations in the price of the security – and, in turn, links the loss causation requirement directly to damages. That is, because plaintiffs may recover damages in an amount limited by events following a corrective disclosure, it follows

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[2] Like the fraud-on-the-market presumption, the lookback provision relies on the notion that efficient markets synthesize relevant public information in pricing stocks. It thus assumes that in the absence of a corrective disclosure, any artificial valuation caused by the fraud will continue to be reflected in the price of the security.

that the "loss" for which those damages provide compensation must similarly be defined by what happens once the alleged fraud is finally revealed. Indeed, in this respect the statute rejects the very premise of the Ninth Circuit's decision: that a plaintiff's loss (and thus his damages) can be measured at the time that he purchases the security at issue. Instead, the statute decrees that both are to be assessed based upon the market's reaction to a corrective disclosure that brings the fraud to light.

So understood, the lookback rule works in tandem with the loss causation provision to further Congress's goal of tightening the substantive and procedural requirements for private securities litigation. The former fixes the maximum damages that the plaintiff may recover, while the latter insists that plaintiffs may obtain *only* the portion of that maximum that was actually attributable to the defendant's fraud. The Ninth Circuit's approach, which decouples plaintiffs' "loss" from the damages they are eligible to receive, is entirely inconsistent with this scheme.

B. The Ninth Circuit's decision undermines the unity of the PSLRA by creating two different definitions of loss causation

Nor can the decision below be reconciled with Section 105 of the PSLRA. Section 105 amended Section 12 of the Securities Act of 1934, 15 U.S.C. § 77l(a), by giving defendants in cases brought under that provision an affirmative defense of loss causation.[3] See 15 U.S.C. § 77l(b). This defense allows the defendant to show that "any portion or all of the amount recoverable * * * represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted." *Ibid.* Any such portion or amount not

[3] Section 12 confers a private right of action against those who, under certain circumstances, make false or misleading statements in connection with the sale of securities.

traceable to the false statement "shall not be recoverable." *Ibid.*[4]

Section 105 thus expressly defines "loss causation" as that which links the defendant's false statements and the "depreciation in value of the subject security." In other words, the PSLRA views loss causation as the device that distinguishes those portions of a security's post-transaction decline that relate back to the fraud from those that do not. It asks whether there were *post-transaction factors* – unrelated to the deceptive statements – that were actually responsible for some, or all, of the plaintiff's ultimate financial loss.

This statute's express definition further dooms the Ninth Circuit's analysis. For, if loss causation in Section 12 cases allows defendants to point to the existence of post-transaction events as reasons for the loss, loss causation in Rule 10b-5 cases should equally require plaintiffs to plead and prove the *absence* such events. In holding otherwise and defining loss causation in terms of purchase-time inflation, the court below left the same term with two fundamentally different meanings in the same statute. "This result is contrary to the basic canon of statutory construction that identical terms within an Act bear the same meaning." *Estate of Cowart* v. *Nicklos Drilling Co.*, 505 U.S. 469, 479 (1992); see also *Sullivan* v. *Stroop*, 496 U.S. 478, 484 (1990); cf. *United Savings Ass'n* v. *Timbers of Inwood Forest Assocs.*, 484 U.S. 265, 371 (1988) (noting that a provision that may seem ambiguous in one context is often clarified "by the remainder of the statutory scheme – because

[4] The same loss causation defense has long existed in cases brought under Section 11 of the Securities Act of 1934, 15 U.S.C. § 77k(e)(3). See *Akerman* v. *Oryx Communications, Inc.*, 810 F.2d 336 (2d Cir. 1987) (defendant may reduce his liability by "proving that *the depreciation in value* resulted from factors other than the material misstatement in the registration statement") (emphasis added). And it is well accepted that the "causation analysis under § 11 is essentially the same as Rule 10b-5's proximate cause element." *Rebenstock* v. *Deloitte & Touche*, 907 F. Supp. 1059, 1065 (E.D. Mich. 1995).

the same terminology is used elsewhere in a context that makes its meaning clear").

III. THE DECISION BELOW IMPROPERLY CONFLATES LOSS CAUSATION WITH TRANSACTION CAUSATION

The PSLRA's definition of loss causation is entirely consistent with the Rule 10b-5 case law that had evolved prior to the statute's enactment. As long as loss causation has existed, it has been understood as a separate and distinct element from that of transaction causation. A 10b-5 plaintiff must satisfy *both* in order to recover. See *Burke* v. *Jacoby*, 981 F.2d 1372, 1378 (2d Cir. 1992); *Arthur Young & Co.* v. *Reves*, 937 F.2d 1310, 1327-28 (8th Cir. 1991); *Currie* v. *Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988). Transaction causation asks what caused the plaintiff to invest in the first place; loss causation asks what caused the investment to lose money. In derogation of this longstanding separation – as well as the express codification of loss causation as an independent requirement in 10b-5 cases – the decision below impermissibly conflates these two requirements, thereby stripping loss causation of its independent force in fraud-on-the-market securities fraud cases such as this one.

In *Basic Inc.* v. *Levinson*, 485 U.S. 224, this Court held that, under certain circumstances, private plaintiffs in cases brought under 10b-5 are entitled to a rebuttable presumption that they relied on public misrepresentations made by the defendant that would have led a reasonable investor to misjudge the value of the security. In this way, plaintiffs need not prove that they themselves were aware of the allegedly misleading statements made by the defendant, but can instead rely on the market's absorption of that information. The theoretical justification for this so-called "fraud-on-the-market" presumption is that efficient capital markets incorporate all relevant public information (whether that information is accurate or not) into the transaction price of the security: "Because most publicly available information is reflected in market price, an investor's

reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247.

Under the approach to loss causation adopted below, however, any plaintiff who satisfies the presumption of reliance by pleading that the defendant publicly made a false statement that may have inflated the transaction price has, *a fortiori*, satisfied the pleading requirement for loss causation as well. The Ninth Circuit's loss causation rule requires merely an allegation that "the price at the time of purchase was overstated and sufficient identification of the cause" (Pet. App. 9a). But this is nothing more than a restatement of the standard for transaction causation adopted in *Basic*. The Ninth Circuit offered no justification for a rule that merges the two requirements in this way, despite the fact that such an approach has been repeatedly rejected by other circuit courts. See *AUSA Life Ins. Co.* v. *Ernst and Young*, 206 F.3d 202, 216 (2d Cir. 2000) ("Loss causation is a separate element from transaction causation, and, in situations such as the instant one, loss causation cannot be collapsed with transaction causation."); *id.* at 226 (Jacobs, J., concurring) ("Loss causation requires the plaintiffs to prove more than simply that E&Y induced them to enter into an ultimately unsuccessful investment. Such a 'but-for' analysis would collapse loss causation into transaction causation."); *Robbins* v. *Kroger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997) (refusing to use the *Basic* presumption "to alter the loss causation requirement" because that theory "is used to support a rebuttable presumption of reliance, not a presumption of causation"); cf. *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 547 (5th Cir. 1981) (it is "a nonsequitur to conclude that the representation that induced action necessarily caused the consequences of that action").

By ignoring these well-established principles, the Ninth Circuit has created a serious tension with the PSLRA's express codification of that element. The result is to deprive CPAs (and others) of a crucial safeguard that Congress intended them to have against inventive plaintiffs' lawyers who are able to find

an arguable violation of professional accounting and auditing standards (as explained below, this is not difficult in light of the nature of those standards), but who are not able to show that the eventual revelation of the violation made any difference to the value of their clients' investments.

In so doing, the Ninth Circuit upended the traditional focus of the loss causation requirement on events occurring *after* an investor purchases a security. (In contrast to transaction causation, which focuses on purchase-time events.) The purpose of that post-transaction focus was to emphasize that not every instance in which fraud may have induced an investor into purchasing securities is actionable under Rule 10b-5. See *Bastian* v. *Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir. 1990). By permitting loss causation to be satisfied solely on the basis of purchase-time events, the decision below makes it irrelevant that intervening forces unrelated to the fraud may actually have caused the investment to lose money. The consequences of such a holding are unfortunate:

> After any drop in price – even if * * * it is entirely unrelated to defendant's conduct – a subsequently dissatisfied investor would be able (with the benefit of hindsight) to point to any allegedly misleading positive statement issued by anyone * * * and couple that with an allegation that the price of the security was inflated as a result to satisfy loss causation. To allow such a claim would invite self-serving testimony, strike suits and protracted discovery.

In re Merrill Lynch & Co. Research Reports Securities Litig., 273 F. Supp. 2d 351, 366 n.28 (S.D.N.Y. 2003).

Finally, the Ninth Circuit's holding conflicts with the central premise of the fraud-on-the-market doctrine. The presumption that this Court endorsed in *Basic* rests on the premise that an efficient market incorporates public misrepresentations into the price of the security at the time of the investment. See 485 U.S. at 246 ("[T]he market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."). By the same token, until an

alleged misrepresentation is corrected and the market learns the truth, any artificial inflation will remain in the price of the stock. So long as the market continues to believe the alleged falsehood, the market will continue to (over)value the stock accordingly.

This means that unless and until the misinformation is publicly corrected, investors – even those who may have paid "too much" – have not actually been injured by that misrepresentation. The investors can simply sell on the market and thereby recover the amount that they overpaid. See *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000) ("In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price."); *In re Initial Public Offering Securities Litig.*, 297 F. Supp. 2d 668, 672-73 (S.D.N.Y. 2003) ("So long as the amount of inflation is constant, artificial inflation causes no loss for customers who buy and sell at inflated prices."). As such, the decision below distorts the loss causation requirement by inexplicably describing as a "loss" an inflationary premium that may still belong to the plaintiff. A recovery of damages under those circumstances would represent a pure windfall justified by no plausible conception of corrective justice.[5]

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[5] Take an obvious example. An investor purchases a stock that should be worth $50 a share at an artificially inflated price of $70 based on false financial statements that overstate the company's earnings. The market never learns of the falsity in the financial statements and so the share price remains at $70. The next day, an earthquake destroys the company's main factory and its stock price drops to $60. The Ninth Circuit's approach would allow the investor to satisfy loss causation based on the purchase-time "inflation," even though that disparity remains in the stock price and could readily be recovered by selling the shares. Allowing recovery under those circumstances is both economically and legally unjustifiable: the plaintiff has suffered no economic loss that actually related to the defendant's misrepresentations, except in the but-for (and thus legally insufficient)

For these reasons, the deflation of the inflationary effect – generally through a corrective disclosure – is an essential aspect of loss causation that the plaintiff must plead to survive a motion to dismiss and must prove in order ultimately to prevail. It cannot merely be assumed away as the court of appeals did in this case. Thus, where (as here) plaintiffs are allowed to satisfy the transaction causation requirement based on the inflated stock price attributable to the alleged misrepresentation, they should be precluded from satisfying loss causation unless and until they allege and show that the price correspondingly deflated once the truth came out. See *Robbins*, 116 F.3d at 1448 (requiring evidence that the "price inflation was removed from the market price"). The Ninth Circuit's rejection of that requirement means that, in an auditing case, plaintiffs could recover from a CPA for *any* downturn in the value of their investment, regardless of whether that fall was actually caused by the alleged defects in the audit report. Such limitless recovery would effectively convert auditors into insurers, strictly liable for whatever ill-fortune besets investors in the audited company.

IV. THE NINTH CIRCUIT'S UNDULY BROAD DEFINITION OF LOSS CAUSATION IMPOSES EXCEPTIONAL BURDENS ON ACCOUNTING FIRMS ENGAGED IN AUDIT WORK

Ensuring that the loss causation requirement is applied correctly is of paramount importance to the AICPA and its members. As explained above, the weakened form of loss causation adopted by the court below undermines the PSLRA's express goal of preventing vexatious private securities litigation by relieving plaintiffs of any burden of showing that their investment loss was actually caused by the alleged fraud. By misconstruing that requirement as it did, the Ninth Circuit gutted a critical 10b-5

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sense that is already captured by the fraud-on-the-market presumption. This simply is not an acceptable view of loss causation.

element designed to separate truly victimized investors from opportunistic ones.

This is an especially serious problem for certified public accountants. Under the Ninth Circuit's rule, any CPA responsible for auditing the financial statements of a company whose stock subsequently declines faces liability to a set of plaintiffs who may not be able even to allege – much less prove – that the decline was *in any way* related to the auditor's actions. And, given the expense of discovery and litigation in securities fraud class actions, and the threat of crippling jury verdicts from those that do go to trial, the pressure to settle cases that are not dismissed early on can become enormous. See *Blue Chip Stamps*, 421 U.S. at 740. This means that accounting firms – which often are targeted as defendants because others more directly responsible for the alleged fraud have become judgment-proof – may be compelled to compensate plaintiffs even though there is no meaningful connection between the plaintiffs' loss and any auditing errors that may have been committed.

A. The highly judgmental nature of financial statement auditing makes violations easy to allege and difficult to rebut

These risks are especially severe in light of the nature of financial statement auditing. Federal law requires that many categories of financial statements, including those submitted in connection with a publicly traded company's annual report, be reviewed by an independent auditor. See *United States* v. *Arthur Young & Co.*, 465 U.S. 805, 810-11 (1984). Auditing is an analytic process designed to "add[] credibility to the information communicated by the accounting process." DOUGLAS R. CARMICHAEL, ET AL., AUDITING CONCEPTS AND METHODS 10 (6th ed. 1996) [hereinafter AUDITING CONCEPTS]; see also *Arthur Young*, 465 U.S. at 819 n.15 ("The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the nation's industries.").

It is essential to distinguish the auditing of corporate financial statements from the job of actually preparing them. Responsibility for the latter lies in the hands of a company's management. See AUDITING STANDARDS, AU § 150.02. The role of an outside auditor, in turn, is to provide an independent, professional opinion as to whether those financial statements fairly present the company's financial position in conformance with Generally Accepted Accounting Principles (GAAP). See *Edenfield* v. *Fane*, 507 U.S. 761, 769 (1993). GAAP encompasses all the conventions, rules, and procedures that collectively define accepted accounting practices at a particular time. See CARMICHAEL, AUDITING CONCEPTS 10. It derives from a number of sources, including standards promulgated by AICPA and the Financial Accounting Standards Board (FASB), prevalent industry practice, as well as expert literature. The purpose of GAAP is to provide those who prepare financial statements with the professionally acceptable way (or ways) to account for a given transaction.

As this Court has recognized, however, GAAP is "far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions." *Thor Power Tool* v. *Commissioner of Internal Revenue*, 439 U.S. 522, 544 (1978). Quite the contrary,

> GAAP changes and, even at any one point, is often indeterminate. "[T]he determination that a particular accounting principle is generally accepted may be difficult because no single source exists for all principles." There are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question. When such conflicts arise, the accountant is directed to consult an elaborate hierarchy of GAAP sources to determine which treatment to follow.

Shalala v. *Guernsey Mem. Hosp.*, 514 U.S. 87, 101 (1995) (quoting R. KAY & D. SEARFOSS, HANDBOOK OF ACCOUNTING AND AUDITING, ch. 5, at 7 (1994 Update)). In addition to being multifaceted and indeterminate, much of GAAP amounts to

little more than "aspirational norms." *Bily* v. *Arthur Young & Co.*, 3 Cal. 4th 370, 380, 834 P.2d 745, 750 (Cal. 1992). Because the relevant guidelines may be stated at an extremely high level of generality, the claim that a violation has occurred is often easy to make and difficult to refute.

These are the complex criteria against which auditors are expected to evaluate corporate financial statements. To determine whether a set of statements complies with GAAP, certified public accountants rely on a variety of tests and procedures consistent with Generally Accepted Auditing Standards (GAAS). These standards define a range of procedures that a CPA may perform in the course of performing an audit. "The basic function of an audit under GAAS is to allow the auditor to formulate an opinion as to whether the financial statements present fairly the data with which the auditor has been presented." Michael R. Young, *The Liability of Corporate Officials to Their Outside Auditors for Financial Statement Fraud*, 64 FORDHAM L. REV. 2155, 2162-63 (1996).

Historically, the AICPA has had primary responsibility for developing GAAS. GAAS comprises ten core auditing standards, adopted by the membership of the AICPA in 1948 and 1949, and revised by the Auditing Standards Board (ASB). See CARMICHAEL, AUDITING CONCEPTS 13. In addition, the ASB has developed and issued 101 Statements on Auditing Standards (SAS) through a process involving public comment. See SAS No. 95, Codification of Statements on Auditing Standards, AU § 105.03 (AICPA 2002).[6] GAAS also requires auditors to be aware of and consider certain AICPA interpretive

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[6] These basic auditing requirements are quite broad and open-ended. For example, according to General Standard 3, "[d]ue professional care is to be exercised in the performance of the audit and the preparation of the report." Similarly, Field Work Standard 2 provides: "A sufficient understanding of the internal ntrol structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." CARMICHAEL, AUDITING CONCEPTS 13.

publications, including AICPA's guides and statements of position, as well as publications interpreting the SAS. Professional publications such as journals and textbooks round out this hierarchy and provide somewhat more detailed (although less authoritative) guidance to auditors in the field. See *id.*; see generally Roger Buffington, *A Proposed Standard of Common Law Liability for the Public Accounting Profession*, 5 S. CAL. INTERDISCIPLINARY L.J. 485, 489-90 (1997). Under Section 103 of the Sarbanes-Oxley Act of 2002, Pub. L. 107-204 (July 30, 2002), authority to issue Professional Auditing Standards governing CPAs in the preparation and issuance of audit reports was conferred upon the Public Company Accounting Oversight Board (PCAOB). See 15 U.S.C. § 7213.[7]

It is important to note that even audits performed in full compliance with GAAS cannot guarantee that every problem lurking in the financial statements will be discovered. Because it is impossible to evaluate every single transaction, even for a small business, auditors invariably rely on sampling techniques to test the accuracy of financial statements. See Robert W. Berliner, *Audit Reports*, 440 PRACTICING LAW INSTITUTE Lit. 41, 55 (July-August 1992). "Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class." SAS No. 39 (AU 350.01); see also *Bily*, 834 P.2d at 749 (noting that "an audit rarely, if ever, examines every financial accounting transaction in the records of a business"). The test nature of financial auditing, although essential to the process, does decrease the reliability of an audit as, by definition, it means that some errors in a given set of financial statements may go unreviewed and thus undetected.

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[7] The PCAOB is a private, non-profit corporation created by the Sarbanes-Oxley Act to supervise and regulate the auditing of public companies. Although not an agency of the federal government, 15 U.S.C. § 7211(b), PCAOB is overseen by the SEC, which appoints its chairman and members. See *id.* at § 7211(e).

This challenge is compounded by the fact that outside auditors must rely heavily on the financial data provided by the audited company. Audits are, by their very nature, conducted in an environment largely controlled by the client. See *Bily*, 834 P.2d at 762. Although it is appropriate for CPAs to maintain a degree of professional skepticism about the information they are given, and not blindly accept the representations of management, it is simply not possible for an auditor to unearth any and all misleading assertions that the company includes in its financial statements. "An auditor is a watchdog, not a bloodhound." *Bily*, 834 P.2d at 762.[8]

It is for these reasons that CPAs do not certify that audited financial statements are accurate. The audit report instead states that in the opinion of the auditor the statements are a "fair representation" or ("fairly present") the actual financial position of the audited company. The issuance of an unqualified (*i.e.* clean) audit report – even one that satisfies all of the requirements of GAAS – does not and cannot "ensure or

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[8] In October 2002, amidst the recent corporate and accounting scandals, the ASB promulgated a new auditing standard for addressing potentially fraudulent financial statements. See SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, AU § 316. The purpose of this new standard was to shift the focus of financial auditing more to the detection and prevention of management fraud. This corresponds with the duty previously imposed on auditors by the PSLRA to take steps to increase the likelihood of detecting fraud. See 15 U.S.C. § 78j-1(a) (audits of financial statements must include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statements amounts"). Even under this standard, however, the auditor is required only to obtain "reasonable assurances" that fraud has not occurred. SAS No. 99 recognizes that, given the nature of fraud – and of financial auditing – even a perfect audit will not necessarily expose concealed chicanery on the part of corporate managers. See Sally L. Hoffman, *The CPA's Professional Standards: What Are They? Who Sets Them? What Are the Key Issues Today?*, SJ077 ALI-ABA 119, 144 (May 2004).

warrant the accuracy of the financial statements." CARMICHAEL, *supra*, at 9. Indeed, an "audit does not guarantee that a client's accounts and financial statements are correct any more than a sanguine medical diagnosis guarantees well-being; indeed even an audit conducted in strict accordance with professional standards countenances some degree of calibration for tolerable error which, on occasion, may result in a failure to detect material omission or detection." *In re Ikon Office Solutions*, 277 F.3d 658, 673 (3d Cir. 2002).

Given the way in which accepted accounting principles change over time and resist being reduced to a series of bright-line rules, an auditor's application of GAAS requires an exercise of discretionary professional judgment. It does not involve the mechanical application of mathematical formulae and is closer to an art than a science. The factors that inform the auditor's judgment are numerous and complex, as are the professional standards that define a job well done. At bottom, then, an audit opinion is just that: an *opinion*. It is not – and cannot be – an objective statement of fact. See Jay Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17, 54 (2003) [hereinafter *Accountants' Liability*]. The California Supreme Court has aptly described this essential quality of an audit report:

> [T]he report is based on the auditor's interpretation and application of hundreds of professional standards, many of which are broadly phrased and readily subject to different constructions. Although ultimately expressed in shorthand form, the report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage. Using different initial assumptions and approaches, different sampling techniques, and the wisdom of 20-20 hindsight, few CPA audits would be immune from criticism.

Bily, 834 P.2d at 763. AICPA's standards are clear about this, explicitly providing that "a properly designed and executed

audit may not detect a material irregularity." SAS 53 (§ 316.07) (AICPA 1989).

Despite these realities, however, an "expectations gap" persists between what CPAs expect of an audit and what the public (and often the courts) expect. See Richard I. Miller & Michael R. Young, *Financial Reporting and Risk Management in the 21st Century*, 65 FORDHAM L. REV. 1987, 2016 & n. 129 (1997). This gap contributes to an environment in which investors are likely to blame auditors for unforseen corporate collapses and to sue them when they occur. The allegation that a CPA ran afoul of some aspect of the general rules of GAAS or failed to identify one of the myriad potential GAAP violations is easy to make and difficult to rebut. Courts routinely invoke such alleged violations in sustaining claims against auditors. See, *e.g.*, *Rhode Island Hosp. Trust Nat'l Bank* v. *Swartz*, 485 F.2d 847, 852 (1st Cir. 1972); *In re Anchor Communications, Inc.*, 22 F. Supp. 2d 999, 1005-06 (D. Minn. 1998); *In re Miller Indus., Inc.*, 12 F. Supp. 2d 1323, 1332 (N.D. Ga. 1998). Especially in a declining market, where the bursting of a bubble leaves many investors with significant losses, bringing suit against an auditing firm based on an allegedly deficient audit can be an easy way to try to recoup those losses. And the Ninth Circuit's loose approach to loss causation wrongly allows such suits to go forward unimpeded.

B. Because auditors are especially vulnerable to vexatious securities class actions, they will be greatly harmed by the weakened loss causation rule adopted by the Ninth Circuit

In addition to the expectations gap, there are other reasons why CPAs are inviting targets for expansive notions of securities fraud liability. In the wake of a corporate failure, the auditor is often the last one standing. In many cases, the issuer responsible for the allegedly misleading financial statements has gone bankrupt or become otherwise judgment-proof, leaving the CPA as the only entity from which plaintiffs can hope to recover their investment losses. See Daniel L. Brockett, *Line*

Between Primary and Secondary Liability Still Blurred in Securities Cases, 50 FED. LAWYER 29, 30 (Aug. 2003). Indeed, between 30 and 40 percent of securities fraud cases against auditors involve companies that are in, or about to enter, bankruptcy. See Zoe-Vonna Palmorose, *Who Got Sued?* J. OF ACCOUNTANCY ONLINE (March 1997), available at www.aicpa.org/pubs/jofa/march97/whosued.htm. Thus, despite having played a secondary role limited to testing the allegedly misleading financial statements against a complex and open-ended set of professional standards, accounting firms frequently emerge as the lone defendant financially able to satisfy a judgment. See Feinman, *Accountants' Liability* at 57.

Given their exposure to potentially vast liability, as well as their concern for their professional reputations, accounting firms may be forced to settle even where the merits of a suit are dubious. Against this backdrop, a robust loss causation requirement guards against the prospect that auditors will be made to cover investment losses for which their actions were in no way responsible. The loss causation element serves as an essential safety net for CPAs accused of fraud, one ensuring that auditors will be liable only to those investors who were actually harmed as a result of a misstated audit opinion. Unless that requirement is construed as Congress intended – as a way to force plaintiffs to plead and prove that their losses were in some meaningful way connected to the fraud about which they complain – CPAs will continue to be threatened with unchecked liability from a class of disappointed investors who do not allege, and cannot prove, that they lost money as a result of anything that the auditor said or failed to say.

The Ninth Circuit's holding in this case significantly undermines that crucial aspect of loss causation and thereby moves the securities laws closer to what they were never intended to be: a form of cost-free insurance for disappointed investors. See *Huddleston*, 640 F.2d at 549. The securities laws do not promise or deliver comprehensive investor insurance. The costs of investment losses caused by factors other than fraud must be assumed by investors, not by

professionals such as CPAs, lawyers, and market analysts. That, at any rate, was exactly the reason that Congress codified the loss causation rule when it sought to rein in private securities class actions in the PSLRA. Allowing lawsuits to proceed solely on allegations of transaction causation, which would leave CPAs vulnerable to suit in the case of *any* audit that could be alleged to have been imperfect, over-deters auditors, over-compensates plaintiffs, and fundamentally distorts the nature of Rule 10b-5. Accord *Bastian*, 892 F.2d at 685 ("No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation. Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities.").

Failure to take loss causation seriously – thereby subjecting auditors to virtually unchecked litigation exposure – has serious social and economic consequences. Securities litigation is extremely costly; one study found that it costs an auditor an average of $3.7 million to defend itself against even a weak securities fraud class action. See Palmrose, *supra*. In the years immediately preceding passage of the PSLRA, it was well documented that rampant class action litigation against CPAs under Rule 10b-5 made accounting firms increasingly unwilling to perform audits for clients perceived as risky, such as those in financial distress, smaller or less-well established companies (including start-ups), and companies operating in volatile industries such as technology. See Frederick L. Jones & K. Raghunandan, *Client Risk and Recent Changes in the Market for Audit Services*, 17 J. ACCT. & PUB. POL'Y 169, 179 (1998).[9]

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[9] Class action litigation against accounting firms did decrease in the first years after passage of the PSLRA, a trend undoubtedly helped by this Court's holding in *Central Bank of Denver*, 511 U.S. at 191, that aiding and abetting liability was not available under Section 10(b). See SEC, Office of the Gen. Counsel, *Report to the President and the*

A shrinking supply forces companies with fewer resources to endure higher prices for legally required financial audits. Such high-risk firms are particularly dependent upon the imprimatur of a well-established, well-respected auditor in order to gain the confidence of the market. Depriving them of quality auditing services makes it more difficult for the growth sectors of the economy to develop to their full potential. *Central Bank of Denver*, 511 U.S. at 189. For, even where litigation risk does not lead CPAs to forego doing audits altogether, they will typically insist on higher fees to high-risk clients, costs that audited companies will undoubtedly attempt to pass on to consumers. See Jamie Pratt & James D. Stice, *The Effects of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Fees*, 69 ACCT. REV. 639, 655 (1994). Empirical studies have also shown that litigation against an audit firm – even, or perhaps especially, frivolous ligation – hurts the stock price of an auditor's *other* clients. See Diana R. Franz, et al., *The Impact of Litigation Against an Audit Firm on the Market Value of Nonlitigating Clients*, 13 J. ACCT. AUDITING & FIN. 117 (1998).

Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995, at 22 (Apr. 1997), available at www.sec.gov/news/studies/lreform.txt. More recently, however, there has been a resurgence in litigation alleging accounting fraud and targeting CPAs. See Kevin P. Roddy, *Seven Years of Practice and Procedure Under the Private Securities Litigation Reform Act of 1995* (July 24-26, 2003). In 2002, accounting-related cases represented 68 percent of all private securities class actions, up from 47 percent in 1996. Settlements in accounting cases comprised 67 percent of all securities-related settlement amounts in 2002. PriceWaterhouseCoopers LLP, *2002 Securities Litigation Survey*, at 4. It has thus been accurately observed that accounting fraud seems to have become "the 'complaint of choice' for private securities class action plaintiffs." *Ibid.* Independent auditors were named in 34 of these cases, up from 18 the previous year. In absolute terms, 2002 had the highest number of cases against auditors since 1998, when 39 cases were brought. See *id.* at 7.

Finally, the expansive approach to loss causation embraced by the Ninth Circuit gives a windfall to plaintiffs that is not necessary to ensure that potential wrongdoers are deterred. There is no reason to fear that applying the loss causation requirement correctly will somehow create a gap in the enforcement of the securities laws. First, the SEC is not required to prove either loss causation or transaction causation when it brings an enforcement action under Section 10(b). See Br. of the SEC, *Amicus Curiae*, in Support of Appellants, *Schoenfeld Asset Mgmt. Corp.* v. *Cendant Corp.*, Nos. 99-5356; 99-5355 (3d Cir. Sept. 1999), at 12; *SEC* v. *Blavin*, 760 F.2d 706, 711 (6th Cir. 1985). The federal government thus always retains the power to take appropriate action against individuals and firms that engage in fraud proscribed by the federal securities statutes, regardless of whether any particular investors suffered financial harm as a result of that fraud. There is neither need nor reason to extend that expansive law enforcement power to private plaintiffs by redefining loss causation as the court of appeals has done in this case. Indeed, doing so potentially delegates too much enforcement power to unaccountable plaintiffs' lawyers, trenching on the SEC's prosecutorial discretion to bring suit in cases where no individual investor has suffered an injury fairly traceable to the alleged fraud.

Separate and apart from SEC enforcement, the auditing of public companies subject to the securities laws is now monitored and regulated by the PCAOB. The Board is charged with overseeing audits "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." 15 U.S.C. § 7211(a). The Board has broad supervisory and regulatory powers over auditors and is empowered to investigate and bring disciplinary charges against accounting firms for violations of the securities laws. See *id.* at § 7215. In addition, state accountancy boards have wide-ranging disciplinary authority over the accountants whom they

license to practice. This thorough supervision of public company accounting practices both demonstrates the lack of need for a relaxed loss causation rule and raises the possibility that adopting such a rule will lead to excessive regulation through private litigation in which plaintiffs cannot meaningfully connect the loss they suffered with the auditor's actions.

CONCLUSION

For the foregoing reasons, the judgment of the Ninth Circuit should be reversed.

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SEPTEMBER 2004

(16)

No. 03-932

IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JAMES C. BLAIR; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF BROADCOM CORPORATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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September 13, 2004

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STATEMENT PURSUANT TO RULE 29.6

Pursuant to Supreme Court Rule 29.6, *amicus curiae* Broadcom Corporation states that it has no parent corporations and that there is no publicly held company that owns 10% or more of Broadcom Corporation's stock.

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Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF BROADCOM CORPORATION AS *AMICUS CURIAE* IN SUPORT OF PETITIONERS

This brief is filed on behalf of Broadcom Corporation as *amicus curiae* in support of petitioners, with the written consent of the parties.[1]

[1] As required by Rule 37.6 of this Court, *amicus curiae* submit that no party or counsel for a party to this case authored this brief in whole or in part, and no person or entity other than *amicus curiae* or its counsel has made a monetary contribution to the preparation or submission of this brief.

INTEREST OF *AMICUS CURIAE*

Broadcom Corporation ("Broadcom") is headquartered in Irvine, California and provides semiconductor solutions that enable broadband communications and networking of voice, video, and data services. Thus, Broadcom is one of the many technology companies located within the jurisdiction of the United States Court of Appeals for the Ninth Circuit. Like many technology companies, Broadcom has a volatile stock price—one that regularly rises and falls more than the stock market as a whole.

The Ninth Circuit's liberal and incorrect standard for pleading loss causation impacts Broadcom's ability to engage in efficient competitive behavior and its ability to raise capital to the detriment of the high technology sector of the U.S. economy. The Ninth Circuit's loss causation standard subjects Broadcom (and all other companies with volatile stock prices) to greater risk of liability in unfounded class action lawsuits seeking damages under Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)") and Rule 10b-5 promulgated thereunder. Given the volatility in Broadcom's stock price, any stockholder who wishes to seek insurance for investment losses can at least for pleading purposes quite easily allege the element of loss causation following a purported material misrepresentation, as that element has been defined by the Ninth Circuit in *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir. 2003), cert. granted, 124 S. Ct. 2904 (2004). In *Broudo* the Ninth Circuit held that mere allegations that a stock price was inflated at the time of purchase are sufficient to allege loss causation. This lenient standard increases the ability of plaintiffs to prosecute and potentially obtain artificially high damage awards in securities fraud lawsuits—especially against companies with volatile stock prices—even where the actual losses that are complained of are not caused by any misrepresentation or other wrongdoing by the company.

In contrast, the loss causation standard articulated by the Eleventh Circuit in *Robbins v. Koger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997) and the Second, Third, and Seventh Circuits (the "majority circuits") more sensibly requires stockholders to plead and prove a causal connection between a misrepresentation and an actual decline in the price of a company's stock. This standard facilitates more efficient competitive behavior on the part of companies, allowing them to take appropriate economic risks and raise capital to the benefit of the high technology and other sectors of the U.S. economy. With rising global competition, it becomes increasingly important to ensure that U.S. companies in the high-technology sector can effectively compete and increasingly important that this Court adopt the majority circuit's loss causation standard.

Broadcom has a further interest in this proceeding because it is currently a defendant in a securities class action lawsuit pending in the United States District Court for the Central District of California. The plaintiff recently submitted an expert report purportedly premised on—and definitely dependent upon—the Ninth Circuit's loss causation standard claiming damages in excess of $5.6 billion. It is no coincidence that the class period in the case is from July 31, 2000 through February 27, 2001—a period that overlaps with the collapse of the stock market in the U.S., and of the high-technology sector of the U.S. economy in particular. The liability issues in the case center around whether a non-cash accounting charge should have been classified as goodwill (as Broadcom was initially advised by its independent auditors) or as a charge against revenues (as the company and its auditors later concluded). The plaintiff, by submitting an expert report seeking damages of over $5.6 billion, is plainly attempting to recover losses that were caused by the general decline in the stock market, as the size of the reclassified non-cash charge during the class period was only $38.6 million. The disconnect between the damages claim in the plaintiff's

expert report and the liability issues would not even be arguably possible absent the Ninth Circuit's erroneous loss causation standard.

SUMMARY OF ARGUMENT

The loss causation element of Section 10(b) and Rule 10b-5 must answer the question why a stockholder lost money on an investment and not just why a stockholder made an investment. The standard applied by the majority circuits recognizes this important legal and economic principle while, at least at the pleading stage, the Ninth Circuit standard does not. The Ninth Circuit's rule that loss causation can be pleaded simply by alleging stock price inflation at the time of purchase obscures the primary importance of the actual stock price decline upon disclosure of the misrepresentation in establishing loss causation. If this rule were applied to measure recoverable damages, it would result in windfall damages to stockholders who have suffered no loss caused by a misrepresentation. Additionally, the current uncertainty in the law encourages plaintiffs to seek unfounded expert testimony on damages.

The potential windfalls resulting from the Ninth Circuit's standard are best illustrated by analyzing the damages awarded to in-and-out traders—*i.e.*, those who both purchase and sell stock before the "truth" is revealed. While in-and-out traders might lose money on an investment, their losses are not *caused* by the misrepresentation. By definition, in-and-out traders sell before the market learns of the purported fraud, and therefore any decline in the stock price between the purchase and sale by an in-and-out trader must have been caused by something other than the purported fraud. Nonetheless, class action plaintiffs and their counsel routinely argue that the Ninth Circuit loss causation standard allows in-and-out traders to recover damages. In contrast, the standard applied in the majority circuits—which emphasizes the stock price decline when the market learns of the misrepresentation—results in no such windfalls and compensates stockholders only for losses actually caused by a misrepresentation.

To ensure that stockholders do not recover damages for stock price declines that are not caused by any misrepresentation, this Court should reverse the decision of the United States Court of Appeals for the Ninth Circuit and hold that a stockholder must demonstrate an actual causal connection between a misrepresentation and a decline in the value of a stock in order to recover damages under Section 10(b) and Rule 10b-5.

ARGUMENT

I. PERSONS WHO PURCHASE AND SELL STOCK BEFORE THE MARKET BECOMES AWARE OF A MISREPRESENTATION CANNOT ESTABLISH LOSSES CAUSED BY THE MISREPRESENTATION

The different loss causation standards applicable in the Ninth Circuit and in the majority circuits directly impact the class of persons who can recover damages under Section 10(b) and how a plaintiff might prove that its losses were caused by a misrepresentation. Respondent claimed in its Supplemental Brief in Response to Solicitor General's Brief for the United States as Amicus Curiae ("Supp. Opp.") that damages for in-and-out traders are calculated the same way under both loss causation standards. *See* Supp. Opp. 1-2. This assertion is legally and economically incorrect.

An in-and-out trader purchases stock at an artificially inflated price, but also sells at an artificially inflated price. The inflation *caused* by the misrepresentation is not eliminated until the market learns of the misrepresentation either through a corrective disclosure by the company or otherwise. *See* Brief for the United States as Amicus Curiae 10-11 (May 2004); *Semerenko v. Cendant Corp.*, 223 F.3d

165, 185 (3d Cir. 2000) ("[i]n the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price"), cert. denied, 531 U.S. 1149 (2001); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997) (no evidence "price inflation was removed from the market price" before corrective disclosure); *see also In re Cendant Corp. Litig.*, 264 F.3d 201, 228 n.8 (3d Cir. 2001) (where "fraud was not revealed until after trading ended on April 15, 1998, [] the stock price before April 16 was at least as artificially inflated by the fraud . . . as it was at the purchase"), cert. denied, 535 U.S. 929 (2002). Thus, even if the stock price fell between the time of purchase and the time of sale, the in-and-out trader's loss is not caused by the misrepresentation. There could not have been a correction in the market price resulting from a correction of the misrepresentation because the market still knew nothing of the misrepresentation at the time of the in-and-out trader's sale. The in-and-out trader should not receive any damages.

The loss causation standard applicable in the majority circuits yields this economically correct result. The in-and-out trader in these circuits receives no damages because it cannot satisfy the loss causation standard which requires an actual causal connection between the decline in the price of the stock before the in-and-out trader sold and the misrepresentation. *See Bastian v. Petren Res. Corp.*, 892 F.2d 680, 684-85 (7th Cir. 1990), cert. denied, 496 U.S. 906 (1990); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000), cert. denied, 531 U.S. 1149 (2001); *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198-99 (2d Cir. 2003). In contrast, in the Ninth Circuit, the in-and-out trader may seek to recover damages even though its losses were not caused by the misrepresentation. The Ninth Circuit's loss causation standard can

be argued to require only that the stockholder allege that the market price was inflated at the time of purchase, and the in-and-out trader can often meet this standard. *See Broudo v. Dura Pharm., Inc.*, 339 F.3d 933, 938-39 (9th Cir. 2003), cert. granted, 124 S. Ct. 2904 (2004). Thus, the in-and-out trader in the Ninth Circuit recovers the artificial inflation in its purchase price when it sells its stock at the still inflated price and then may obtain a windfall if it receives damages in a securities class action.[2]

The differences between the standards are illustrated in the following hypothetical example:

- **Hypothetical**: Traders A and B purchased stock in Company X for $100 per share after Company X issued a press release containing misleading information. If Company X had not issued the misleading press release, its stock price on the date Traders A and B purchased would have been $90. Company X stock falls to $60 before the misleading press release is corrected. Company X stock then falls an additional $10 per share immediately after Company X issues a press release correcting its earlier misleading press release. Trader A sold its stock at $50 after Company X's corrective disclosure while

[2] This discussion assumes that the in-and-out trader sells its stock before there is any correction in the market price of the stock caused by the misrepresentation. If, however, an in-and-out trader sells after a partial correction in the market price (due, for example, to a partial disclosure of the prior misrepresentation) but before complete correction of the market price, the in-and-out trader can demonstrate some loss caused by the misrepresentation. Of course, a stockholder who purchased at the exact same inflated price as the in-and-out trader and sold only after a complete correction in the market price would still suffer greater losses caused by the misrepresentation than the in-and-out trader. Even in this situation, the loss causation standard applied by the majority circuits yields the correct result while the Ninth Circuit standard might overcompensate the in-and-out trader.

Trader B sold its stock at $80 before Company X's corrective disclosure.

- **Majority Circuits:**
  - Trader A receives damages of $10 per share because Trader A can demonstrate an actual causal connection between the $10 decline in value of Company X stock and the misrepresentation given that Company X's correction of its misleading press release caused the stock price to fall $10.
  - Trader B receives no damages because Trader B cannot establish an actual causal connection between the misrepresentation and the decline in value between its $100 purchase price and its $80 sale price. Company X's stock fell from $100 to $80 for reasons unrelated to the misrepresentation and thus Trader B's losses were not caused by the misrepresentation.[3]
- **Ninth Circuit:**
  - Trader A will argue that it should receive damages of $10 per share because the market price on its date of purchase was inflated by $10 per share.
  - Trader B will also argue that it should receive damages of $10 per share because the market price on its date of purchase was inflated by $10 per

[3] Even if the amount of the artificial inflation was lower at the time Trader B sold than at the time it purchased, Trader B's loss was not caused by the fraud (which was still unrevealed). Loss causation must serve to limit recoverable damages to those that actually result from the fraud. *See, e.g.*, 15 U.S.C. § 77k(e) (defining damages for a violation of Section 11 of the Securities Act of 1933 but limiting "recoverable" damages to those actually caused by the misrepresentation).

share. Even though Trader B's loss was not caused by the misrepresentation, Trader B might receive damages and a windfall of $10 per share.[4]

The differences in the loss causation standards are also nicely illustrated by comparing the hypothetical case presented in the Ninth Circuit's decision in *Wool v. Tandem Computers Inc.*, 818 F.2d 1433 (9th Cir. 1987) with the Seventh Circuit's decision in *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir. 1990). In *Wool*, the Ninth Circuit presents an example where a company issues a misleading statement indicating that it has discovered oil when in fact it has not, causing its stock price to increase by $10. Thereafter, a different company announces its own discovery of oil causing a decrease in the price of oil and a resulting $5 decline in the price of the first company's stock. The Ninth Circuit states that an in-and-out trader who sold before the fraud was revealed but after the decline in the price of oil suffered a recoverable loss of $5. *See Wool*, 818 F.2d at 1437 (citing *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345-46 & nn.6-10 (9th Cir. 1976)). In contrast, in *Bastian*, the Seventh Circuit held that persons who invested in oil and gas limited partnerships failed to establish that their losses were caused by fraud when the value of the partnerships fell because of a worldwide decline in the price of oil. *See Bastian*, 892 F.2d at 684.

[4] The potential windfall to in-and-out traders from the Ninth Circuit's loss causation standard (if applied to measure recoverable damages) not only adversely impacts defendants in securities class actions, but given that most securities class actions are settled before trial, also reduces the funds available to satisfy claims by non in-and-out traders who must share any settlement proceeds with in-and-out traders. Thus stockholders who actually suffered losses caused by a misrepresentation would obtain smaller recoveries because some funds would be distributed to in-and-out traders who did not suffer losses caused by a misrepresentation.

The decision in *Bastian* is correct. At the time of its sale, the hypothetical stockholder in *Wool* thought it owned exactly what it thought it owned when it purchased – stock in a company that had recently discovered oil. The stockholder voluntarily took the risk that the price of oil would fall, and oil prices fell for reasons not related to the alleged fraud. Even if the company had been exactly as represented (*i.e.*, it had discovered oil) its stock price would still have fallen and the hypothetical stockholder would still have lost the $5 resulting from the market decline. Thus, the hypothetical stockholder's $5 loss was not caused by the misrepresentation.

These examples help demonstrate the incoherence of the Ninth Circuit's loss causation standard which might award windfall damages to stockholders who have not suffered any investment losses caused by a misrepresentation. The standard applied by the majority circuits in contrast ensures that stockholders receive compensation only for losses actually caused by the misrepresentation.[5]

II. LOSSES CAUSED BY A MISREPRESENTATION SHOULD BE MEASURED BY THE DOLLAR DECLINE, AND NOT THE PERCENT DECLINE, WHEN THE MARKET LEARNS OF THE MISREPRESENTATION

By permitting plaintiffs to plead loss causation based solely on a showing of inflation at the time of purchase, the Ninth Circuit's loss causation standard exacerbates another economic anomaly in measuring recoverable damages. Losses

[5] Of course, the inflation in the stock price at the time of purchase provides a cap on the damages that a stockholder can recover under Section 10(b) and Rule 10b-5 in order to limit damages to out-of-pocket losses. For example, if a stockholder overpays $10 when it purchases stock and the stock price falls $20 on disclosure of the fraud, the stockholder's maximum recovery is $10, its out-of-pocket loss.

caused by a misrepresentation should be measured by the dollar decline when the market learns of a misrepresentation. Using the percent decline as opposed to the dollar decline leads to perverse results. Regardless of whether a company's stock price rises or falls during the class period, the percent method can distort the determination of damages. For example, the percent method can lead both to awards of damages to stockholders who suffered no losses caused by a misrepresentation and to different treatment of stockholders whose actual losses caused by a misrepresentation are the same.

Plaintiffs' experts generally use what is termed the constant percent method or percent method to estimate the losses caused by a misrepresentation. The constant percent method assumes that a misrepresentation inflates the market price of a stock by the same percent regardless of the stock price. Thus, if the percent inflation caused by a misrepresentation is 17% and the stock price is $100, then the dollar inflation caused by the misrepresentation in the stock price is $17.00 (17% of $100). If, however, the price of the stock falls to $80 for reasons unrelated to the misrepresentation, the constant percent method assumes that the dollar inflation caused by the misrepresentation is $13.60 (17% of $80).

The constant percent method results in windfall damages to certain stockholders because it fails to limit awards to losses *caused* by a misrepresentation. This windfall is illustrated by analyzing Trader B's damages in the hypothetical from Section I. As discussed above, Trader B (the in-and-out trader) both purchased and sold before disclosure of Company X's misrepresentation. Thus, Trader B cannot establish a causal connection between its losses and Company X's misrepresentation and should not recover damages. Under the constant percent method, however, Trader B could receive windfall damages. Trader B will claim that the price of Company X stock fell from $60 to $50 (or 17%) upon correction of the misrepresentation. Thus using the constant

percent method, Trader B will argue that it paid $17 per share in artificial inflation when it purchased Company X stock (17% of the $100 purchase price) and only recouped $13.60 in artificial inflation when it sold Company X stock (17% of the $80 sale price). Thus, under the constant percent method Trader B will claim damages of $3.40 per share even though none of its losses were caused by the misrepresentation.

The constant percent method also results in incorrect damage recoveries to stockholders who buy stock and hold it long-term. Suppose an example where two stockholders purchased Company Y stock during a period when Company Y stock is artificially inflated by a misrepresentation. One stockholder purchased the stock at $100 while the other stockholder purchased the stock at $200. The reason for the difference in the purchase prices for the two stockholders was not related to the misrepresentation. After the revelation of the misrepresentation, Company Y's stock price fell from $50 to $40 (20%). Neither of the two stockholders sold their stock. Under the constant percent method, the stockholder who purchased at $100 will argue that it should receive damages of $20 per share (20% of the $100 purchase price) while the stockholder who purchased at $200 will argue that it should receive damages of $40 per share (20% of the $200 purchase price). This result is inconsistent with loss causation because both stockholders suffered the same damages caused by the misrepresentation, *i.e.* $10 per share. The percent method is flawed because it overcompensates both stockholders in this example and because it awards different recoverable damages to stockholders who suffered precisely the same loss.

The only way to measure the decline in value *caused* by a misrepresentation (and not to award windfall damages to persons whose losses were not caused by a misrepresentation) is to use the dollar (not the percent) decline in value when the market learns of the misrepresentation. The dollar decline

provides an objective measure of the real-world losses caused by a misrepresentation. This, in turn, will reduce the extent to which damages analysis becomes a battle of experts in a field involving highly technical statistical and econometric studies which courts and juries are ill equipped to understand and apply. It also measures damages based on the actual losses caused to stockholders when they learn that they had not purchased what they thought they had purchased. Of course, one cannot simply use the gross dollar decline on the day a misrepresentation is corrected because that decline includes market, industry, and company specific factors not related to the misrepresentation. The dollar decline that should be used to calculate damages caused by a misrepresentation must be a statistically significant residual dollar decline after taking into account market, industry, and company specific factors unrelated to the alleged fraud. The loss causation standard applied by the majority circuits properly recognizes these principles by measuring loss based on the actual decline in stock price caused by a misrepresentation while the Ninth Circuit standard arguably does not.

CONCLUSION

The examples presented in this brief demonstrate that the different loss causation standards applied by the majority circuits on the one hand and the Ninth Circuit on the other hand are not mere "semantic" differences as Respondents state. *See* Response in Opposition to Petition for a Writ of Certiorari 13. The loss causation element prevents Section 10(b) and Rule 10b-5 from "becom[ing] an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission." *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), aff'd in part, rev'd in part, 459 U.S. 375 (1983). The Ninth Circuit standard could result in windfall benefits that are economically unjustified and legally incorrect, while the standard applied by the majority circuits ensures that

stockholders are compensated only for damages actually caused by misrepresentations and not for declines in stock prices that were not caused by misrepresentations.

The decision of the United States Court of Appeals for the Ninth Circuit should be reversed.

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INTEREST OF THE *AMICUS CURIAE* [1]

The Chamber of Commerce of the United States (the "Chamber") is the world's largest business federation. The Chamber represents an underlying membership of more than three million businesses and organizations of every size, in every industry sector, and from every region of the country. The Chamber regularly advocates the interests of its members in court involving issues of national concern to the American business community.

The Chamber has a substantial interest in the issue presented in this case: the proper application of the loss causation principle in securities litigation. Securities class action litigation imposes an enormous toll on the national economy, affecting virtually every public corporation in America at one time or another and costing American businesses billions of dollars in settlements every year. Indeed, recent studies conclude that, over a five-year period, the average public corporation faces a 9% probability of facing *at least* one securities class action lawsuit. *See* Elaine Buckberg et al., NERA, *Recent Trends in Securities Class Action Litigation: 2003 Early Update* 4 (Feb. 2004) ("*2003 Early Update*"). As Congresswoman Anna Eshoo (D-Cal.) has put it, "Businesses in my region place themselves in one of two categories: those who have been sued for securities fraud and those that will be."[2]

Because of pressures unique to securities class action litigation, virtually all claims that survive initial motions practice are settled. With little prospect that their claims will be fully tested by the adversarial process, plaintiffs

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[1] Pursuant to Supreme Court Rule 37.6, counsel for *amicus* represents that they authored this brief and that no entity other than *amicus*, its counsel, or its members made a monetary contribution to its preparation or submission. All parties have consented to the filing of this *amicus* brief, and letters reflecting their consent have been filed with the Clerk.

[2] Conference Report on H.R. 1058, Private Securities Litigation Reform Act of 1995, 141 Cong. Rec. H14039, H14051 (Dec. 6, 1995).

have a strong incentive to bring securities class action claims without regard to their underlying merit. By diverting resources away from productive economic uses, meritless securities actions threaten to slow the spread of new investments, reduce the efficiency of capital markets, and limit the competitiveness of the American economy. The membership of the Chamber thus has a strong interest in ensuring that the requirements of the federal securities laws are applied in a correct and uniform manner, weeding out meritless suits as quickly and regularly as practicable, in order to avoid undue harm to the nation's commerce and industry.

SUMMARY OF ARGUMENT

While the statutory and legislative history arguments for reversal are familiar, what may not be so apparent is the practical impact of the Ninth Circuit's ruling in contemporary securities class action litigation. Simply put, the court of appeals' decision, if affirmed, would make what is already a bad situation very much worse.

First, due to pressures unique to American securities litigation, businesses are typically forced to settle even meritless suits. Unless a case can be dismissed through early motions practice, the subsequent threat of class certification forces corporate executives to choose between staking the future of their companies on the outcome of a single jury verdict, or settling even when they may have no legal liability.

Securities class action suits, moreover, often benefit class counsel more than they do class members, with settlement payments simply involving a transfer of wealth from current shareholders to former shareholders, minus, of course, contingent attorneys' fees that typically run between 19% and 45%. As one leading securities class action plaintiff's lawyer has candidly admitted: "I have the greatest practice in the world because I have no clients. I

bring the case. I hire the plaintiff. I do not have some client telling me what to do. I decide what to do."[3]

Second, into this environment the Ninth Circuit's holding introduces a new legal rule that only further encourages plaintiffs to file and companies to settle meritless claims by removing a key safeguard against such suits. Worse still, the Ninth Circuit's rule encourages risky investment behavior, effectively forcing issuers to insure against speculative losses having nothing to do with their own conduct. Under the Ninth Circuit's rule, an investor can file a claim and obtain recovery even when the disclosure of an allegedly fraudulent statement has absolutely *no effect* on the stock price. To estimate damages in the absence of any contemporaneous real world stock price movement, moreover, the Ninth Circuit's rule requires litigants (and courts) to resort to exactly the sort of "junk science" economics this Court has consistently discouraged. And because it permits claims for any allegedly false statement, without respect to demonstrated market injury, the Ninth Circuit's rule has the effect of chilling investment advice and reporting within the securities industry.

By contrast, the alternative loss causation rule endorsed by the Government, petitioners, and four circuits[4] would avoid all of these problems while ensuring full recovery of real losses, consistent with the established tort principle that, although "the consequences of an act go

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[3] *See In re Network Assocs., Inc. Sec. Litig.*, 76 F. Supp. 2d 1017, 1032 (N.D. Cal. 1999) (quoting attorney William S. Lerach).

[4] The court of appeals below acknowledged that this interpretation of the loss causation requirement differed from the standards articulated by the Third and Eleventh Circuits. *See Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997). The court of appeals did not, however, cite or discuss the additional conflicting decisions of the Second and Seventh Circuits. *See Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003); *Bastian v. Petren Res. Corp.*, 892 F.2d 680 (7th Cir. 1990).

forward to eternity, . . . legal responsibility must be limited to those causes which are so closely connected with the result." W. Page Keeton et al., *Prosser and Keeton on Torts* § 41, at 264 (5th ed. 1984).

ARGUMENT

I. THE PRESSURE TO SETTLE EVEN MERITLESS SECURITIES CLASS ACTIONS IMPOSES AN ENORMOUS TOLL ON THE AMERICAN ECONOMY

This Court has long recognized that securities fraud litigation presents "a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975). Because the amount of damages demanded can be so great, corporations are frequently forced to forgo the adversarial process, settling even meritless suits in order to avoid the prospect of bankruptcy. Indeed, studies indicate that, unless a securities class action is dismissed on the pleadings, it is virtually certain to settle. *See* Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2064 (1995); Woodruff-Sawyer & Co., *A Study of Shareholder Class Action Litigation* 25 (2002) (83% of securities fraud cases are resolved through settlement).

So great is the pressure on corporations to settle that, even when defendants *do* succeed in obtaining a trial court dismissal, the risk of losing on appeal can still lead to enormous settlements. By way of example, just earlier this year one securities defendant agreed to settle a pending class action for $300 million even *after* the suit was dismissed on the merits with prejudice in the trial court.[5]

[5] Jonathan Weil, *Win Lawsuit —and Pay $300 Million*, Wall St. J., Aug. 2, 2004, at C3.

To be sure, Congress has sought to address these problems, passing the Private Securities Litigation Reform Act ("PSLRA") in 1995 and the Securities Litigation Uniform Standards Act in 1998. Despite these efforts at reform, however, the number of securities class actions has not declined. *See* Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003* (May 2004) ("*PSLRA Settlements*"). Quite the opposite, in fact, has occurred: in the six years since the enactment of the PSLRA, the mean number of securities fraud suits has risen by an astonishing 32%. *See* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. Ill. L. Rev. 913, 930. Another published study has concluded that, following the enactment of the PSLRA, public companies now face a nearly 60% *greater* chance of being sued by shareholders. *See 2003 Early Update*. And the dismissal rate of securities fraud lawsuits between 1996 and 2003 averaged only 8.4%, with dismissals in three of the 11 federal circuits averaging *just 4%*, a result that Congress hardly anticipated or intended. *See id.* at 5.

Just as the number of cases continues to rise despite congressional efforts to rein them in, class members all too often continue to find themselves in the unfortunate position of losing regardless of the outcome of these cases. Because payments come out of corporate coffers, securities class actions frequently involve only "a transfer of wealth from current shareholders to former shareholders." Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487, 1503 (1996).[6] Thus,

[6] *See also* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611, 638-39 (1985); *see also* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. Ill. L. Rev. 691, 698-700; Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639, 650 & n.48 (1996); Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. Ill. L. Rev. at 921-22.

to the extent that class members still own shares in the company at the time of the suit (as they often do), "payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up." *Id.* As Judge Friendly once remarked, securities fraud litigation carries the risk of "'large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.'" *Blue Chip Stamps*, 421 U.S. at 739 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968)).

A recent case against Qwest Communications illustrates the phenomenon. There, plaintiffs' counsel sought to increase the pressure on defendants to settle by moving to freeze approximately $400 million of potential proceeds from a planned sale of a Qwest business unit.[7] The plaintiffs' lawyers claimed that the sale should be enjoined to ensure that the as-yet-to-be certified class (and its counsel) would get paid if they ultimately won the suit. But Qwest badly needed the proceeds from the sale to avoid bankruptcy.[8] The district court eventually denied the motion and expressly found that a freeze would not benefit all putative class members or the company, but only former shareholders and the attorneys.[9] According to the court, entering the injunction sought would likely have bankrupted the company and rendered worthless the stock of thousands of would-be class members who were still shareholders in Qwest.[10]

Securities class actions are also frequently filed so quickly after a stock price decline that any reasonable fac-

[7] *In re Qwest Communications Int'l, Inc. Sec. Litig.*, 243 F. Supp. 2d 1179 (D. Colo. 2003).

[8] Press Release, Qwest Communications, *Qwest Communications Statement In Response to Motion Filed by Milberg Weiss Bershad Hynes & Lerach LLP* (Nov. 4, 2002).

[9] *Qwest Communications*, 243 F. Supp. 2d at 1186-87.

[10] *Id.* at 1188.

tual investigation into the merits is simply impossible. By way of example, one court found it "peculiar that four of the lawsuits consolidated in this action were filed around 10:00 a.m. on the first business day following [the defendant's] announcement" and that "[m]ost of the complaints are virtually identical (including typographical errors)."[11] At the hearing on the defendant's motion to dismiss, the judge inquired "How did you get to be so smart and to acquire all this knowledge about fraud from Friday to Tuesday? . . . On Friday afternoon did your client suddenly appear at your doorstep and say 'My God, I just read in the *Wall Street Journal* about Travelers. They defrauded me,' and you agreed with them and you interviewed them and you determined that there was fraud and therefore you had a good lawsuit, so you filed it Tuesday morning, is that what happened?" The court noted that "[c]ounsel for the plaintiffs was not responsive to this line of inquiry."[12]

Efforts at reform notwithstanding, virtually all securities class action cases continue to be settled with little or no regard to their underlying merit. As Congress, the courts, and commentators have all observed, "[t]oo frequently, corporate decisionmakers are confronted with the implacable arithmetic of the class action: even a meritless case with only a 5% chance of success at trial must be settled if the complaint claims hundreds of millions of dollars in damages." H.R. Rep. No. 106-320, at 8 (1999).[13] The

[11] *Ferber v. Travelers Corp.*, 785 F. Supp. 1101, 1106 n.8 (D. Conn. 1991).

[12] *Id.* (brackets omitted).

[13] *See also West v. Prudential Sec., Inc.*, 282 F.3d 935, 937 (7th Cir. 2002) (noting scholarly concerns that "settlements in securities cases reflect high risk of catastrophic loss, which together with imperfect alignment of managers' and investors' interests leads defendants to pay substantial sums even when the plaintiffs have weak positions"); Victor E. Schwartz et al., *Federal Courts Should Decide Interstate Class Actions: A Call for Federal Class Action Diversity Jurisdiction Reform*, 37 Harv. J. on Legis. 483, 490 (2000) ("For defendants, the risk

magnitude of the continuing pressure to settle even strike suits is perhaps most clearly exposed by the fact that, since the PSLRA's passage, more than 2,000[14] securities fraud cases have been filed in federal court, yet defendants have taken less than 1% to trial.[15] As one observer commented over a decade ago in words equally applicable today, there is simply "*no appreciable risk* of non-recovery" in securities class actions. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 578 (1991).[16] Merely "*[g]etting the claim into the legal system*, without more, sets in motion forces that ultimately compel a multi-million dollar payment." *Id.* at 569 (emphasis added). *Accord Hevesi v. Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004) (noting "numerous courts and scholars have warned that settlements in large [securities] class actions can be divorced from the parties' underlying legal positions"); *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001) (discussing the "inordinate or hydraulic pressure on [securities fraud] defendants to settle, avoiding the risk, however small, of potentially ruinous liability").

of participating in a single trial [of all claims], and facing a once-and-for-all verdict is ordinarily intolerable.") (internal quotation marks omitted).

[14] *See* Stanford Law School & Cornerstone Research, Securities Class Action Clearinghouse, *at* http://securities.stanford.edu/companies.html.

[15] Richard Painter et al., The Federalist Society for Law and Public Policy Studies, *Private Securities Litigation Reform Act: A Post-Enron Analysis* 8 (2003), *at* http://www.fed-soc.org/pdf/PSLRAFINALII.PDF ("*PSLRA Analysis*").

[16] As the Second Circuit has observed, "[a]necdotal evidence tends to confirm [Professor Alexander's] conclusion. Indeed, [Melvyn I.] Weiss and his partner William S. Lerach of the Milberg firm have stated that losses in these cases are 'few and far between,' and they achieve a 'significant settlement although not always a big legal fee, in 90% of the cases [they] file.'" *Goldberger v. Integrated Res., Inc.*, 209 F.3d 43, 52 (2d Cir. 2000) (quoting *In re Quantum Health Res., Inc. Sec. Litig.*, 962 F. Supp. 1254, 1258 (C.D. Cal. 1997)).

It is well known, too, that the same few law firms bring the great bulk of these claims. One recent study found that, since the passage of the PSLRA, a single firm (recently split into two) has been involved as lead or co-lead plaintiffs' counsel in over 50% of securities class action settlements.[17] In the cases where competition for lead counsel status does emerge, accusations are sometimes exchanged by the plaintiffs' bar that one or another firm has offered to "pay off" competitors to withdraw their applications to serve as lead counsel, leading at least one court to observe that

> [w]hile over a dozen law firms participated early on in this litigation, only two filed proposals to represent the class, and only one of these proposals appears serious. This suggests an understanding or collaboration among plaintiff firms engaged in securities class action litigation that many would choose not to bid for this litigation . . . . The indicia of such cooperation raises serious doubts about the conditions of competition in this segment of the legal services industry.[18]

Commenting on the phenomenon of contemporary securities class action litigation, a Florida court described the whole process as "the class litigation equivalent of the 'Squeegee boys' who used to frequent major urban intersections and who would run up to a stopped car, splash soapy water on its perfectly clean windshield and expect payment for the uninvited service of wiping it off." *Fruchter v. Florida Progress Corp.*, No. 99-6167CI-20, 2002 WL 1558220, at *10 (Fla. Cir. Ct. Mar. 20, 2002).

[17] *See PSLRA Settlements* at 14 (discussing the Milberg Weiss Bershad Hynes & Lerach firm, now divided into two separate partnerships known as Milberg Weiss Bershad & Schulman, and Lerach Coughlin Stoia Geller Rudman & Robbins); *see also PSLRA Analysis* at 15-16.

[18] *In re California Micro Devices Sec. Litig.*, No. C-94-2817-VRW, 1995 WL 476625, at *4 (N.D. Cal. Aug. 4, 1995).

Simply put, despite Congress's clear intent and two efforts at reform, American business continues to contend with "precisely the sort of lawyer-driven machinations the PSLRA was designed to prevent." *In re BankAmerica Corp. Sec. Litig.*, 95 F. Supp. 2d 1044, 1050 (E.D. Mo. 2000) (criticizing the "outrageous" attempts of plaintiffs' counsel to commandeer the class action for their own benefit), *aff'd*, 263 F.3d 795 (8th Cir. 2001). The drain on the American economy and its global competitiveness is substantial. In the last four years alone, securities class action settlements have exceeded two billion dollars *per year*.[19] And the problem continues to grow. In 2002, the average price of settling a securities fraud claim rose to $24.3 million, a 68% increase from 2001. *See* Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2002*, at 3 (May 2003). In 2003, the average settlement value for accounting-related securities fraud cases reached $26.5 million. *2003 PricewaterhouseCoopers Securities Litigation Study* (rel. Aug. 2, 2004), *at* http://www.10b5.com/2003_study.pdf.

II. THE NINTH CIRCUIT'S RULE WOULD SIGNIFICANTLY EXACERBATE THE PROBLEMS AND INCREASE THE SOCIAL COSTS ASSOCIATED WITH MERITLESS SECURITIES CLASS ACTIONS

"The economics of sanctions starts from the proposition that the objective of a legal rule is to deter certain undesirable behavior without simultaneously deterring (too much) beneficial behavior." Easterbrook & Fischel, *Optional Damages in Securities Cases*, 52 U. Chi. L. Rev. at 612. The Ninth Circuit's rule disregards this fundamental objective in many notable and problematic respects.

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[19] *See PSLRA Settlements* at 1. In 2000 alone, the total value of securities fraud cases (adjusted for inflation) was estimated at $4.428 billion. *Id.* Settlements in 2001 were estimated at $2.1 billion, rising to $2.537 billion in 2002, and holding at $2.016 billion in 2003. *Id.*

A. Rather than holding companies liable for the damage they inflict, as reflected by actual market events, the Ninth Circuit's rule permits liability to be found and damages to be awarded even when the plaintiff can point to *no actual market price reaction to a corrective disclosure*. By way of example, suppose a plaintiff buys $50 of stock in the defendant corporation. As time passes, the value of the plaintiff's investment declines to $5. *After* this decline, the defendant announces the restatement of an accounting item, yet the plaintiff's shares remain at $5. In most circuits, any subsequent securities class action would be dismissed. By contrast, under the Ninth Circuit's rule, a plaintiff can proceed to trial simply by hiring an expert to render an opinion on how much of the price the plaintiff paid was "inflated" because of the undisclosed accounting issue. Plaintiffs and their lawyers, thus, can obtain a recovery even where investors are not demonstrably hurt by the alleged fraud — including in cases where the plaintiffs sold before the alleged misrepresentation was exposed, or the misrepresentation was never exposed at all, or it was exposed but the market did not respond negatively.

Such a regime serves only to exacerbate the already-intense pressure on companies to settle securities class action suits without regard to their merit. Denying courts any means for weeding out at the pleading stage suits where the alleged fraud had no empirical effect on share price, and thus imposed no demonstrable harm on class members, the Ninth Circuit's rule adds fuel to a fire in which virtually every case is settled, wealth is transferred away from current shareholders and productive economic uses to former shareholders, and lawyers are enriched.

The facts of this case are illustrative. On February 24, 1998, Dura announced a revenue shortfall for the following year, unrelated to any alleged fraud. By the next day, shares in Dura dropped from $39.125 to $20.75 for a one-day loss of 47%. Some *nine months later*, on November 3, 1998, Dura announced for the first time that the United

States Food and Drug Administration had declined to approve its Albuterol Spiros product — an announcement that plaintiffs contend constitutes the first public disclosure of the alleged fraud in this case. Following this announcement, however, Dura shares fell only slightly and briefly. Share prices initially dropped from $12.375 to $9.75, but, within 12 trading days, they recovered to $12.438, ultimately climbing to $14.00 within 90 days of the announcement.

Plaintiffs in this suit, however, never alleged damages based on the brief and shallow $2.625 stock price dip after the November 3 disclosure of the supposed fraud. Rather, they demand recovery based on the much more significant February 24 stock price decline of $19, even though plaintiffs themselves allege no corrective disclosure in that announcement. In short, plaintiffs in this case seek damages based on a decline in share value that occurred nine months *before* the disclosure of the alleged fraud. And it is beyond cavil that a company facing potential liability of $19 per share is in a wildly different posture when it comes to deciding whether to litigate or settle than one facing potential liability of, at most, $2.625 per share.

B. Relatedly, the Ninth Circuit's rule dangerously skews investment incentives. To be sure, speculative investments are a natural — and even beneficial — part of any free and open market: "[I]n stock trading, as elsewhere, speculation serves the salutary purpose of enabling the rapid adjustment of prices to current values." Richard A. Posner, *Economic Analysis of the Law* 458 (6th ed. 2003). Because "[t]he speculator is the eager searcher for undervalued and overvalued securities," information discovered through this search "diffuses rapidly throughout the market." *Id.*

In particular, speculators may be attracted to what economists refer to as "rational bubbles," where a stock's price incorporates all publicly available information without "represent[ing] the true [market] value of the underlying company." Paul A. Ferrillo et al., *The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof from Plaintiffs in Fraud-on-the-Market Cases*, 78 St. John's L. Rev. 81, 114 (2004). Investors might reasonably conclude that an overvalued stock will continue to appreciate during the life of the bubble. *See id.* at 115. These investors realize that "[e]ventually the bubble will burst, of course, but it is always a fair investment until that point." *Id.*

Naturally, the significant potential benefits of speculation also carry a correspondingly high degree of risk. Under the Ninth Circuit's rule, however, much of that risk is transferred away. If the price of a stock investment declines, the speculator can state a claim for relief, and likely obtain a significant settlement, merely by alleging that the defendant made a "misleading" statement — and do so even if the stock failed to decline after a corrective disclosure and moved downward only much later after other news. Such a regime unnaturally encourages risky investments by underwriting speculative losses unrelated to the defendant's conduct, and effectively serves to transform the federal securities laws into "a system of investor insurance that reimburses investors for any decline in the value of their investments." *Robbins*, 116 F.3d at 1447.

C. The Ninth Circuit regime also encourages, and in fact depends upon, a return to the use of "junk science." Because the Ninth Circuit's rule allows recovery where disclosures do *not* prompt any stock price decline, plaintiffs' experts are, by necessity, forced to resort to a grab-bag of speculative theories to estimate damages; and without any negative market reaction to the actual disclosure there is simply no objective way for courts, juries, or opposing parties to check their work. *See Robbins*, 116 F.3d at 1448.

Such a result stands in marked contrast with the Court's repeated attempts to remove precisely this sort of speculation about damages from the federal court system.

Cf. General Elec. Co. v. Joiner, 522 U.S. 136 (1997); *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999); *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 579 (1993). Indeed, the same concerns that spurred the passage of the PSLRA in 1995 — including an abundance of frivolous suits, questionable claims of injury, and speculative theories of causation — prompted the adoption of Federal Rule of Evidence 702 and this Court's holding in *Daubert*.

Both *Daubert* and Rule 702 address the need to ensure that the nexus between a plaintiff's injury and the alleged cause of that injury is supported by reliable evidence. Prior to *Daubert*, courts viewed relevancy under a loose standard that tolerated almost any correlation between cause and injury. Without a rigorous examination of the causal nexus underlying the allegations, "marginal or unreliable" theories of causation regularly proceeded to trial. *See* Kenneth R. Foster et al., *Phantom Risk: Scientific Inference and the Law* 433 (1993).

Daubert and Rule 702 provided courts with the tools to screen out scientifically questionable claims in two ways. First, *Daubert* allowed courts to determine whether a claim is based on a proper temporal logic, where the alleged harmful act precedes the alleged injury. Second, *Daubert* required plaintiffs to exclude other factors, beyond the alleged harmful act, that could have caused their alleged injuries. Together, these guideposts "invite[d] courts to take a hard look" at the causal basis underlying a plaintiff's alleged injury and thus to "act with dispatch" in rejecting speculative, unproven, and unprovable damages claims. Christopher B. Mueller & Laird C. Kirkpatrick, *Evidence* § 7.17, at 740 (2d ed. 1999).

Loss causation under the PSLRA, as interpreted by other circuit courts, achieves this same goal in the securities context. By subjecting securities claims to the requirement of a decline in stock price close in time to the disclosure of the alleged fraud, courts are able to test for

some reliable indication whether plaintiffs' alleged damages were caused by fluctuations in the marketplace due to causes other than the defendant's putative fraud. Like the gatekeeping function endorsed in *Daubert*, the loss causation requirement helps to screen out securities fraud actions built upon "phantom" injuries — cases involving actual harms producing actual suffering, but for which no single cause can be reliably identified. *See* Foster, *Phantom Risk* 1.

Judge Easterbrook has discussed exactly this point in the class certification context, noting that, unless courts insist on a firm "causal link between non-public information and securities prices," they are left with only a "clash" of experts, a situation that amounts "to a delegation of judicial power to the plaintiffs, who can obtain class certification just by hiring a competent expert," leaving defendants subject to damages that have not been — and cannot be — "verified empirically." *West*, 282 F.3d at 938-40.

Such a result, invited by the Ninth Circuit's reasoning, defies the "universal requirement" that any claim sounding in tort must include a sufficient allegation that the defendant's conduct caused the plaintiff's injury, or, stated simply, "[n]o hurt, no tort." *Bastian*, 892 F.2d at 683-84; *see also* Guido Calabresi, *Concerning Cause and the Law of Torts: An Essay for Harry Kalven, Jr.*, 43 U. Chi. L. Rev. 69, 79 (1975). And without a hard look by the courts to ensure "some reasonable connection between the act or omission of the defendant and the damage which the plaintiff has suffered," Keeton, *Prosser and Keeton on Torts* § 41, at 263, litigants risk being exposed to "infinite liability for all wrongful acts," no matter how loosely connected or unrelated such conduct may be to the actual performance of a shareholder's investment, *id.* at 264. There is no reason to presume that Congress sought to endorse such a rule, so alien to traditional tort principles and this Court's holdings in *Daubert* and its progeny,

when it codified the loss causation requirement in the securities fraud arena.

D. The Ninth Circuit's rule, if permitted to stand, will also serve to chill investment advice and reporting and the free flow of information in our capital markets. To date, securities class actions typically have been aimed at issuers and their executives. But without a requirement that plaintiffs tie any alleged disclosure to a timely market effect, no apparent barrier will remain to prevent future litigants from bolder attempts to expand liability to anyone even remotely connected to an investment decision. So long as the market price of a stock is deemed to take account of the communication at issue pursuant to the efficient market hypothesis endorsed in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), investor reliance on that communication is presumed and dissatisfied investors are free to bring class action claims on them. *See Bastian*, 892 F.2d at 685. Accordingly, *any* allegedly false investment information from any source — not just issuers — could conceivably become the basis for triggering liability to *all* investors.

For example, media programs with "talking heads" have become a popular feature on cable television.[20] Internet sites such as "The Motley Fool" also regularly praise investments like Dura Pharmaceuticals. And, of course, investment banks make buy and sell recommendations. Without a legal rule limiting the scope of liability to disclosures that bear a close causal link with specific stock price declines, dissatisfied investors could conceivably bring claims against such sources simply by finding some false statement recommending a stock made before a wide public audience. *See Bastian*, 892 F.2d at 685.

---

[20] *See, e.g.*, CNN, *CNNfn on TV*, *at* http://money.cnn.com/ontv; FOXNews.com, *FNC Shows*, *at* http://www.foxnews.com/business; CNBC, CNBC TV, *at* http://moneycentral.msn.com/cnbc/tv/default.asp.

To avoid this consequence, corporations — along with investment firm stock analysts, media sources touting stocks, and others — will have a strong incentive to limit their discussions to the narrowest possible scope, or cease publishing information on stocks altogether. Such a result, of course, is inconsistent with the very premise of an open capital market, which depends on the freest possible flow of information. *See* Posner, *Economic Analysis of the Law* 457-58 (explaining that "[i]nformation that may mislead some members of the audience may be valuable to others"); *see also Securities Fraud on the Internet: Hearings Before the Permanent Subcomm. on Investigations of the Senate Comm. on Government Affairs*, 106th Cong. 79-91 (Mar. 22-23, 1999) (testimony of Thomas M. Gardner, founder of The Motley Fool, Inc.), *available at* 1999 WL 8085871 ("We believe that technology, especially the Internet, allows people to obtain information that once was the exclusive property of Wall Street professionals, so that they can make their own financial decisions better than the professionals they previously relied upon.").

CONCLUSION

The decision of the court of appeals should be reversed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC., et al,
Petitioner,

VS.

MICHAEL BROUDO, et al.,
Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

BRIEF FOR JAMES J. HAYES AS AMICUS CURIAE SUPPORTING RESPONDENTS

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On Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

BRIEF FOR JAMES J. HAYES AS AMICUS CURIAE SUPPORTING RESPONDENTS

INTEREST OF AMICUS CURIAE

James J. Hayes[1] is an active individual investor with more than 40 years experience buying and selling millions of dollars U.S. equities ranging from speculative IPO's like Radview Software to blue chips like Kimberly Clark. He is a long term owner of Dura purchasing 1,000 shares on 9/26/98

[1] Pursuant to Rule 37.6, James J. Hayes states that no counsel for a party authored this brief in whole or in part and that no person made a monetary contribution to its preparation. The Petitioners' consent to the submission of this brief is submitted with this brief. Respondents have previously filed a blanket consent with the Clerk.

about a month before Dura's Spirios Albuterol new drug application (NDA) was denied by the FDA. He is not a class member, however, and has no direct financial interest in the outcome of this case.

Mr. Hayes is a long time student of equity markets completing, for example, Dr. Frederick Amling's graduate courses in securities and portfolio analysis and Dr. John Kendrick's graduate course in business cycle analysis at the George Washington University.

As an investor, Mr. Hayes is interested in a legal system that protects rights of minority shareholders and fairly compensates shareholders victimized in market based securities fraud. This is particularly germane now with the unprecedented increase in major fraud cases before the courts. A more responsive legal system would improve the efficiency of our equity markets and increase national wealth.

In 1990 Mr. Hayes filed an amicus brief with this Court in Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991); arguing that shareholders were unconstitutionally denied appraisal rights in that takeover. The failure of the courts to provide a remedy for minority shareholders from unfair takeovers affected by majority vote could reduce market efficiency by discouraging investor participation in the markets and causing remaining investors to reduce prices they are willing to pay for individual stocks. Market efficiency improves when investors can confidently bid what they believe a stock is worth without discounting for the probability of exploitation by the majority in a merger or for relying on false corporate disclosures.

In current cases relevant here, Mr. Hayes is a named plaintiff in a proxy fraud (14-a) case against Crown Central Petroleum, its officers and directors, in a takeover by its

largest shareholder. As a class member, he is also protesting the settlement of a classic fraud-on-the-market 10b-5 case against Nice Systems Inc. This Court recently denied a writ of certiorari that case, James J. Hayes vs. Nice Systems Ltd., et al., No. 03-1676. Mr. Hayes anticipates filing a Rehearing Petition on November 29, 2004 after Justice Souter granted petitioner's application to extend time for filing a rehearing petition.

INTRODUCTION

A. Tightening Pleading Requirements For Loss Causation Is The Wrong Solution For the Wrong Problem

The premise underlying the arguments of several amici is that the country is being inundated by wave of meritless securities class action law suits that force defendants to pay nuisance settlements because of the huge amount of potential damages. They lament that despite the 1995 passage of the Private Securities Litigation Reform Act (PSLRA) that American business continue to contend with "*lawyer-driven machinations the PSLRA was designed to prevent.*" (U.S. Chamber of Commerce (Chamber) Br.10, citing In re BankAmerica Corp. Sec. Litg., 95 F. Supp. 2d 1044, 1050 (E.D. Mo. 2000))

The amici' solution to a problem – that amicus Merrill Lynch (ML) characterizes as "blackmail settlements" with "windfall recoveries" – is a single "*rigorous loss causation standard.*" Their strict standard would only apply to fraud that is publicly disclosed by a timely statement that corrects the misleading statements that have previously inflated the corporation's stock price. Absent a correcting disclosure, the suit would be dismissed. The problem, however, is that corporations fraudulently inflating their stock price rarely make a corrective disclosure. Rather corporations are careful

to obscure the fact that their prior statements were false or misleading.

1. Amici' Solution Ignores Recent Wave Of Corporate Fraud

The amici fail to acknowledge that beginning in the late 1990's this country experienced a unprecedented increase in accounting and financial fraud that included the largest U.S. companies including Enron, Worldcom, and Tyco and in some cases the auditors and investment bankers. Enron's auditor, for example, was successfully prosecuted by a special task force in the U.S. Department of Justice for criminal fraud. In response, Congress passed Sarbanes/Oxley to tighten accounting standards and then require the CEO and CFO certify their company's financial statements.

Amici failure to acknowledge the recent wave of security frauds that have shocked millions of investors, raises questions on their credibility; their presumptions on the significance of meritless securities class actions proceeding to settlement and their arguments for tightening loss causation pleadings.

2. Accounting Fraud Is Distinguished From IPO Fraud

The accounting fraud problem is complicated by the internet and dotcom revolution that led a boom in technology stocks in the late 90's that produced an unprecedented increase in new public offerings (IPO's). Spectacular stock gains followed in initial trading which continued until the economy began to slow in 2000. ML characterized the rapid increase in stock prices of recently issued IPO's as a huge stock market "bubble" which simply burst causing trillions of dollars in market losses within a matter of months. However ML didn't explain that the unprecedented price increase in the new IPO's was aided by the allocation practices of major

underwriters. Investigations by the New York Attorney General and the SEC found that certain underwriters tied allocations in their IPO's to requirements to purchase additional stock after the stock began public trading in the market. Such schemes could artificially inflate prices paid by an unsuspecting public. The investigations also determined that certain underwriters' analysts buy recommendations to their brokerage clients did not represent the professional opinions of the analyst. ML Br. 20.

In December 2002, the nations leading underwriters settled these charges for $1.4 billion. ML – who duplicity represents its "*experience with post bubble suits*" as "*useful to the Court*" – paid $200 million in restitution and investor benefits. ML Br. 2 & 26. Typically, ML never issued a corrective disclosure about its analysts' false recommendations and under the loss causation standards it advocates here these suits would be dismissed for failing to plead loss causation.

ML is right that without a corrective disclosure determining investors' damages are complex and uncertain; however, it is clear there was a bubble and ML and other investment bankers were blowing it up. The scheme provided the underwriters enormous fees that were enhanced as the spectacular price gains attracted a growing number of underwriting clients. In the complex world of securities fraud, a general statement pleading loss causation should satisfy the pleading requirements of the PSLRA with the specific amounts of damages determined after discovery allows a full analysis of the complex factors causing the collapse in prices. If ML and other leading underwriters were blowing up a "speculative bubble" shouldn't they share some liability when the "bubble" bursts?

Extensive investigations by Congress, the New York Attorney General, the SEC, the Justice Department and

various U.S. attorneys have shown that the largest and most spectacular of the securities frauds discovered after 1998 were real. Documenting only a few of the frauds has taken an enormous amount of time and continues today, six years after the frauds were active. Indeed it was on November 4, 2004 that the first guilty verdicts were obtained in a single incident in the complex Enron fraud. Four ML investment bankers and an Enron executive were found guilty of fraud in connection with a scheme to inflate Enron's 1999 earnings.[2]

Amici briefs avoid the recent wave of complex securities fraud schemes in arguing that "*meritless securities actions threaten to slow the spread of new investments, reduce the efficiency of capital markets and limit competitiveness of the American economy.*" Chamber Br. 2. On the other hand pre-discovery dismissal of meritorious fraud cases and failure to compensate investors fairly for their fraud losses threatens to drive investors from the market with the same dire consequences identified by the Chamber. The sheer complexity of information effecting today's markets make it impossible to simply dismiss well pled fraud allegations on the presumption that some have little merit. The lengthy investigation of Enron shows that full discovery is required to avoid dismissing the meritorious cases.

3. Reducing Meritless Securities Litigation Requires Balancing PSLRA Dismissals With PSLRA Shareholder Empowerment

There is little evidence to show that more rigorous interpretation of PSLRA pleading requirements are a solution to the problem of meritless securities suits. A Federalist Society study found that the average dismissal rate following PSLRA

[2] Emshwiller & Scannell, *Enron Trial Results in Five Guilty Verdicts – Convictions of Merrill Bankers Show Advisors Can Be Liable For Helping Mislead Investors*. Wall St. J., Nov. 4, 2004 at C-1 E.

was 25.1% more than double the 11.2% dismissal rate prior to the PSLRA.[3] Indeed, Brian Lehman, a legal commentator, argues that a substantial number of meritorious cases are being dismissed because circuit courts are requiring investors to prove their case in the pleadings![4] Lehman cites the pre-discovery loss causation dismissal In re Merrill Lynch & Co., Inc. Research Reports Securities Litig., 273 F. Supp. 2d 351 (S.D.N.LY. 2003) noting that causation is typically considered a question for the jury. A fraud suit against WorldCom was dismissed just three months before the company's internal auditor alerted directors and the public about WorldCom's fraudulent overstatement of earnings that led to its bankruptcy. And finally the Enron fraud could not satisfy the loss causation standard advocated by the petitioner. (See B p17) In the aftermath of unprecedented level of real securities fraud, the important issue is whether significant numbers of meritorious suits are being dismissed prior to discovery.

Now, finally circuit courts have recognized that pre-discovery dismissals are requiring plaintiffs to prove their case in the pleadings. The Seventh Circuit in Asher v. Baxter Int'l Inc. 377 F. 3d 727 (7th Cir. 2004) (Baxter) determined that securities fraud suits cannot be dismissed under the safe harbor provisions of PSLRA prior to discovery.[5] Clearly,

[3] Painter et al., *Private Securities Litigation Reform Act: A Post-Enron Analysis,* The Federalist Society for Law and Public Policy Studies, (2003) at 7, http://www.fed-soc.org/pdf/PSLRAFINALII.PDF

[4] Lehman, *Misinterpretation of fraud statute led WorldCom case dismissal*, Findlaw, http: //www.com/2003/LAW/09/05/findlaw.analysis.lehman.worldcom/

[5] Asher v. Baxter Int'l Inc., 377 F. 3d 727 (7th Cir. 2004) focuses on the safe harbor provisions of PSLRA (15 U.S.C. 77z-2(78u-5(c)) whereby companies can insulate themselves from securities fraud litigation provided they include "*meaningful cautionary statements identifying*

amici arguments for a more rigorous loss causation standard is the wrong solution for the wrong problem at the wrong time.

Dismissing securities class actions prior to discovery pursuant to the enhanced pleading requirements in the PSLRA is only one of the provisions Congress intended to reduce meritless securities suits. According to the SEC, PSLRA made a number of changes to class action procedures to "*empower investors so that they, not their lawyers, control securities litigation*," SEC Br. 14 quoting S. Rep. No. 98, 6.

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important factors that could cause actual results to differ materially from those in the forward-looking statement." Baxter's forward looking statement included a projection that in 2002 revenue would grow in the "*low-teens*" and earnings-per-share would grow in the "*mid-teens*" compared with 2001. By the second quarter of 2002 however, Baxter announced that sales and profits did not match these projections and on that announcement Baxter shares fell from $43 to $32.

The district court determined that Baxter's projections included "*meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.*" and dismissed the complaint for failure to state a claim on which relief may be granted. Baxter at 730.

In overruling the district court, Judge Easterbrook reasoned that: "*any particular caution, which always may be challenged as not sufficiently 'meaningful' or not pinning down the 'important factors that could cause actual results to differ materially.*" Id. 729.

...

Baxter's chosen language may fall short. There is no reason to think... at the pleading stage, before plaintiffs have access to discovery – that the items mentioned in Baxter's cautionary language were those thought at the time to be the 'important' sources of variance. Id. 734.

...

"Thus this complaint could not be dismissed under the safe harbor, though we cannot exclude the possibility that if after discovery Baxter establishes that the cautions did reveal what were, ex ante, the major risks, the safe harbor may yet carry the day." Id. 735.

In particular, settlements of meritless suits provide little benefit to investors but handsome fees for their lawyers. Congress recognized the situation required better disclosure in the settlement notice to provide estimates of damages, attorney fees and plaintiff recovery on a per share basis so that investors and the courts could evaluate the fairness of the settlement. Armed with information, class members could challenge nuisance settlements including attorney fees which do not seem appropriate where class members receive a low recovery. Eliminating attorney fees in settlements that provide little benefit to shareholders would quickly shut off the oxygen fueling meritless suits.

Granting the Hayes petition for writ of certiorari in NICE Systems, Ltd., case number 03-1676 in conjunction with the Dura appeal would enable this Court to reach a balanced interpretation of the PSLRA that would discourage meritless securities class actions and permit shareholders to recover meaningful damages in the meritorious cases.

B. Proscribing Aggregate Damages in Settlements Would Discourage Filing Of Frivolous Securities Class Action Suits

Frivolous securities law suits are driven by the certainty of multimillion dollar fees awarded to class action lawyers for achieving token settlements that provide little or no benefit to class members. Chamber Br. 8 n.16. The Chamber tacitly acknowledges that this rather than lax pleading standards is the driving force behind meritless litigation. "*Securities class action suits, moreover, often benefit class counsel more than they do class members...*" Chamber Br. 2. Even in meritless suits, six and seven figure fees are the norm because the potential damages – even for small companies with actively traded securities – are tens or hundreds of times greater than the settlement. Class lawyers benefit because

they have devised a manipulative settlement evaluation scheme that allows the deduction of legal fees from the gross settlement rather than share the tiny awards to individual class members.

Securities class action settlements are structured to provide a fixed payment to the class regardless of the number of damaged shares. Attorney fees and costs are deducted from the settlement before the pro rata distribution to the class. In frivolous suits, the per share awards allocated to individual class members are insufficient to justify the expense of documenting and filing a claim. By separating attorney fees from the benefits offered individual class members, class counsel is not concerned whether the settlement actually benefits the class. If alternatively, attorney fees were a portion of actual claims filed, nuisance suits would not generate sufficient fees to justify the cost of filing the suit.

In addition to the PSLRA provisions on loss causation are provisions designed to empower class members. The PSLRA requires, for example, that settlement notices sent to shareholders present the settlement in per share terms. 15 U.S.C. 78u4 (7) (C). Attempts to comply with these provisions have resulted in unreliable and meaningless estimates that frustrate evaluation by both the courts and shareholders. The Hayes petition for certiorari in NICE argues that this Court's decision in Daubert v. Merrell Dow Pharmaceuticals, 509 U.S. 579 (1993) proscribes aggregate damage settlements leaving per share settlements as the only alternative. Per share settlement would eliminate the problems with estimating aggregate damages that are foreclosed by Daubert..

Proscribing aggregate damage settlements would reduce or eliminate frivolous securities litigation as lawyers would lose their risk free opportunity for multi-million dollar fee awards for bringing meritless litigation. (Cf. Pet. 12-15;

Reply 2-4) Granting a writ of certiorari on the forth-coming request for rehearing will allow this Court to support a balanced interpretation of loss causation to allow meritorous cases like Dura and Enron as the more speculative cases will simply not enter the courts.

SUMMARY OF ARGUMENT

The petitioner posits that since the passage of the PSLRA in 1995 that the circuit courts have adopted two conflicting standards for pleading loss causation under that statute. One first articulated In. Re.Cendant Corp., 191 F.R.D. 387 (D.N.J. 1998) holds that loss causation requires a stock decline following a disclosure which corrects previous misstatements or omissions.

> Basic liability in this case has been conceded, by the major corporate defendant. No one needs to be reminded that it was Cendant's public admission on April 15, 1998 that spawned this litigation. Id. 389

The second illustrated by the Ninth Circuit here and the Eight Circuit in Gebhardt v. Con Agra Foods Inc., 335 F. 3d 824 (8th Cir. 2003) holds that loss causation can be pled by alleging that the false and misleading statements caused artificial inflation of the stock price.

The conflict however is more apparent than real as the different standards reflect different underlying fact situations. Where corporations admit liability in a public disclosure and a stock price decline follows, the Third Circuit standard is appropriate for pleading loss causation. In most cases, however, corporations do not publicly admit their frauds rather public disclosures are calculated to prevent discovery of the fraud. In cases like Dura and Enron the only way to plead loss causation is to allege that the fraud artificially inflated the stock price.

Distinction should also be made between pleading and proving loss causation. Plaintiffs do not have to prove their case in the pleadings. Judge Easterbrook reiterated this principle in a recent PSLRA case. In reasoning applicable to pleading loss causation, Judge Easterbrook ruled that a PSLRA pleading case couldn't be dismissed before discovery. Asher v. Baxter Int'l Inc., 377 F. 3d 727 735 (7th Cir. 2004)

Petitioners' arguments against the Ninth Circuit standard are duplicitous and disingenuous. They cite a 33Act case, Bastian v. Petren Resources Corp., 892 F 2d 680 (7th Cir), that involved a newly issued oil and gas limited partnership that made no loss causation pleadings whatsoever to argue the "*Ninth Circuit's price-inflation theory of loss causation, ...is revolutionary and would radically alter... how loss causation has been applied in most circuits...*" Pet. Br. 26. Judge Posner was speculating in his opinion on potential facts the plaintiffs would need to plead loss causation in a case that is not remotely related to a fraud-on-the-market case like Dura.

Petitioners most serious argument is based on the presumption underlying the Ninth Circuit standard that investor losses are incurred at the time of the transaction by virtue of paying an inflated price for the stock. Petitioners correctly argue that investors are not damaged at this point as they could easily sell the stock at the artificially inflated price. However, the Ninth Circuit could just as easily presume that the investors losses are incurred later after an anomalous stock price decline reduced all or part of the artificial inflation.

ARGUMENT

A. The Alleged Conflict Among The Circuits On Loss Causation Fails On The Dura Facts

Petitioners' loss causation arguments assume that the $18/share drop in Dura's stock price on 2/25/98 had nothing to do with the probability that Dura's new drug application (NDA) for Spiros albuterol would not be approved. The petitioners attribute the decline solely to Dura's 2/24 announcement of slower drug sales of Ceclor CD and Nasarel/ Nasalide. The petitioners rely on the rejection eight months later on 11/3/98 as evidence that the alleged false statements on Spiros albuterol were not a factor in the 2/25 stock price decline. Br. 28.

Petitioners have a fundamental misunderstanding on how an efficient market works. While it is true that markets evaluate publicly released information, i.e. Dura's announcement of slower sales of Ceclor CD; they also ferret out and evaluate non-public information. Its likely that the bad news on Ceclor CD sales triggered a reassessment of Spiros albuterol based on existing non-public information even though Dura released no new information about Spiros albuterol. The strong form of the Efficient Market Hypothesis (EMH) holds that efficient markets incorporate non-public information in assessing public announcements. [6]

Its clear the prospects for the Spiros device was a co-factor with the increasing Ceclor CD sales in the substantial increase in Dura's stock price during the class period.

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[6] Wikipedia, Efficient Market Hypothesis, http://en.wikipedia.org/wikj/Efficient_market_hypothesis Boehme, Managerial Finance http://www.rdboehme.com/FIN_6335/Chap_13.pdf

Following a 1/20/98 conference call with Dura's CEO, Merrill Lynch informed its clients. "*By 2002, we believe that Spiros based products could contribute up to 50% of corporate revenue*." App. #130, p.107a.

However, as alleged in the complaint, the clinical trials supporting the Spiros albuterol NDA were not successful and Dura executives knew that it was likely that the FDA would not approve the device based on this research. The complaint cites a meeting among Dura executives prior to the filing of the NDA where defendant Prettyman made it very clear that he did not want to file the NDA, for which his department, Regulatory Affairs, was responsible. Prettyman, who worked for the FDA for over ten years, knew the NDA would not be approved. Shortly after this meeting Prettyman sold 15,000 shares of Dura stock on 11/5/97, his only sales during the class period. (App. #96 - #101, pgs. 89a-91a; #125, p. 104a) Such non-public information about a potential company making product would cause a major stock price decline if it was leaked or ferreted out by inquisitive market participants.

Following Dura's 2/24/98 announcement it was apparent to many investors that Dura had lied about the prior sales of Ceclor CD. As Alex. Brown analyst Ryan explained to his firm's Dura investors:

> Management credibility has been severely damaged by this announcement, particularly in light of recent investor conference presentations exuding confidence on the Company fundamentals....
>
> ...
>
> As recently as one month ago, we reviewed our model with the Company line by line and were guided to higher Ceclor CD estimates. App. #134, pgs. 109a-110a.

Investors, discovering that Dura management had lied about prior Ceclor CD sales, would begin frantic efforts to

discover other misrepresentations in order to assess what action should be taken on their Dura stock. Investors would quickly focus on Spiros albuterol, as the success of this product was as important or more important than the sales of Dura's existing drugs.

Contrary to petitioners' assumptions, the omission of any discussion of Spiros albuterol from the 2/24 announcement would raise questions on the likelihood of its FDA approval. In analyzing corporate announcements, investors have learned that companies try to offset bad news with positive news or at least reiterate previous expectations about other important products. The omission of comments on Spirios, the equivalent of damming by faint praise, would raise questions with Dura investors about the prospects for the highly touted Spiros albuterol application. Such questioning could lead to information on the problems encountered with the phase three trials; the division among Dura executives on the Spiros albuterol prospects or that a key executive sold stock days before the Spiros albuterol application was filed with the FDA. Alternatively, investors may have already been aware of these factors but had discounted their significance or reliability until the 2/24 announcement destroyed the credibility of Dura executives.

The Wall Street Journal (WSJ) had questions about Dura's 2/24 announcement and the unprecedented $18/share stock price decline on 2/25. In addition to highlighting the decline in the daily market column, the WSJ sought a fuller explanation. Significantly, officials at Dura couldn't be reached for further comment. The WSJ story quoted a CIBC Oppenheimer analyst who had projected an FDA approval of Spiros albuterol before the end of 1998 based on a 1/20/98 conference call with Dura officials. (App. #130, pgs. 107a-108a.)

Analyst, Steven V. Gerber, put a positive spin on the earnings shortfall speculating that half of the $.50/share

earnings miss was due to the announced sales force expansion. Gerber continued. "*Since they were already missing numbers, I think, they decided to go for broke and really build things up to get the most effective launch*" [for the Spiros product.][7] If this were true, Dura officials would have been happy to comment as this news would mitigate the seriousness of the sales drop of Ceclor CD and show confidence in an early approval of Spiros albuterol.

However, the market price of Dura stock continued to languish following the WSJ story, indicating that investors did not believe the Oppenheimer analyst's explanation. The lack of a market reaction to the WSJ story and the lack of a reaction[8] after the rejection of Spiros albuterol on 11/3/98 shows that the part of $18/share drop was due to the markets reassessment of the probability of Spiros albuterol success.

In summary, the facts alleged in the complaint are sufficient to connect part of Dura's $18/share drop to allegations that Dura had misrepresented the prospects of Spiros albuterol sufficient to satisfy the loss causation pleading requirements of the Third Circuit. If, however, this Court rejects the strong form of the EMH, the entire $18/share drop would be tied to the alleged misleading statements on Ceclor CD. This scenario squares with the more stringent loss causation pleading requirements. The Dura case is simply not one to resolve the perceived conflict among the circuits on the pleading requirements for loss causation.

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[7] Rundle, *Dura Shares Plummet on News That Results Will Miss Forecasts*, Wall St. J. Feb. 26, 1998 at B-10 E.

[8] Even though Dura's stock dropped $3.50/share on the disapproval announcement, the stock shortly recovered the entire loss. The rebound occurred in spite of an FDA action that Dura "sugar coated" the FDA's Spiros albuterol concerns in a press release.

B. There Is Or Should Be No Conflict Among The Circuits On The Pleading Requirements For Loss Causation

The general language in the 34 Act and PSLRA does not establish specific loss causation pleading requirements for private suits alleging 10b-5 violations. Rather the pleadings must demonstrate a causal connection between the 10b-5 violations and the damages incurred by investors. The Ninth Circuit has approved pleadings alleging that the defendant's misleading statements artificially inflated or depressed their stock price. In this scenario, investors' damages is the specific amount that the stock price is inflated or depressed determined by valuation analysis by experts at trial.

However, when the fraud is exposed in a public announcement, courts (including presumably the Ninth Circuit) have accepted pleadings citing the immediate (same day or next day) reaction of an efficient market. There is or should be no conflict in these standards as the particular facts dictate the appropriate standard.

The specific loss causation pleading should reflect the circumstances exposing the fraud. Many if not most securities frauds are not exposed by a single "corrective disclosure" but unwind over an extended period of days or even months making it impossible to correlate a specific stock price decline with the artificial inflation caused by the defendant's misleading statements. The Ninth Circuit's artificial inflation standard presumes an efficient market will discover and correct inflated price, most likely when its stock is in steep decline regardless of the public announcements. (Please see the discussion in D on 26.)

Petitioners' arguments that loss causation pleadings in a fraud-on-the market case always require a corrective disclosure followed by an immediate stock price decline are silly.

This is clearly shown by a cursory examination of the Enron fraud – the largest in history causing tens of billions of dollars damages to investors. The Enron suit, which is currently proceeding in district court in Houston, would be dismissed under the petitioners' loss causation requirements.

The APPENDIX (cited as A_) shows selected news reports from the Oil Daily (OD) chronicling the fall of Enron beginning with the unexpected resignation of its CEO on 8/14/01 to its impending bankruptcy on 11/29/01. Enron's stock price lost nearly all of its value falling from nearly $43/share to $.60/share in three months. However, there was never a "corrective disclosure" indicating that prior statements of earnings or Enron's prospects were false or misleading. Indeed on 8/24/01 the new CEO unequivocally denied that there were any undisclosed accounting issues. A2. The Oil Daily attributed Enron's $6/share price decline on 8/15 & 8/16/01 to a "slew" of business reversals. A1. However, on 9/19/01, Enron stock fell to $29/share after disclosing a $1.2 billion write-off due to the termination of a joint venture between Enron and a limited partnership headed by its CFO. It was only after Enron declared bankruptcy that the partnerships were found central to a fraudulent accounting scheme that allowed Enron to manipulate its earnings and artificially inflate its stock price.

Because there was no "corrective announcement" of the fraudulent partnership activity, it will be difficult to quantify how much of Enron's market decline was due to bad business decisions represented by the real partnership losses and how much was artificial price inflation due to Enron's reported earnings based on fictitious partnership profits.[9] There can be no doubt, however, that fictitious profits artificially inflated Enron's stock price and that investors were damaged when subsequent price declines eliminated the artificial inflation. That amount of inflation would be determined by

an investment banking analysis at trial. Plaintiffs are not required to prove their damages in their pleadings.

Under circumstances where fraud is discovered only after a period of declining stock market prices or is undiscovered, loss causation can only be pled by reference to artificial appreciation due to the alleged misleading statements or omissions. These circumstances are distinguished from those found by district court in Cendant where the company discovered an accounting fraud and quickly announced its discovery to an unsuspecting market.[10] With these rare circumstances, loss causation is or should be pled by reference to the immediate reaction of the market when the truth is revealed. Different pleading standards should reflect different circumstances and not conflicting interpretations among the circuit courts. Plaintiffs pleading loss causation should use the highest pleading standard that the facts allow, a "corrective disclosure" followed by an immediate market decline being the gold standard.

A key 34Act case purportedly showing that the Ninth Circuit's loss-causation pleading standard has been rejected by other circuits can be distinguished and/or shows a disagreement on the meaning of particular facts. In Robbins v. Koger Properties, Inc., 116 F. 3d 1441, 1448 (11th Cir. 1997) the court reversed a jury verdict awarding the plaintiffs an

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[9] A partial "corrective disclosure" came on November 4, 2004 nearly five years after Enron declared bankruptcy when a jury determined that ML and Enron engaged in a sham transaction that allowed the energy company to illegally book about $12 million in pretax profits in 1999. Emshwiller & Scannell, *Enron Trial Results in Five Guilty Verdicts – Convictions of Merrill Bankers Show Advisors Can Be Liable For Helping Mislead Investors*. Wall St. J., 11/4/04 at C-1 E.

[10] In. Re.Cendant Corp., 191 F.R.D. 387 389 (D.N.J. 1998) This decision underlies the Third Circuit's loss causation standards.

estimated $81 million. The circuit court had assumed that the defendants' misrepresentation "artificially inflated the price of [the company's] stock" but would not accept the fact that a stock price decline following the announcement of a 64% reduction in the dividend reduced the artificial price inflation.

First, Robbins is an overturned jury decision in a pre PLSRA fraud-on-the-market case. The appeals court held that no reasonable jury could have concluded that the defendant's misrepresentations were "*in some reasonably direct, or proximate, way responsible for [plaintiffs'] loss.*" Id. 1449 quoting Huddleston v. Herman & MacLean, 640 F 2d. 534 549 (5th Cir.), reversed in part, 459 U.S. 375 (1983). In overturning the jury decision, the appeals court rejected a retrospective application of the Ninth Circuit's artificial price appreciation loss causation standard. However, the appeals court's assessment of the lack of evidence in Robbins, is not relevant to debating pleading standards required to satisfy PSLRA requirements. Nothing in the PSLRA requires plaintiffs to prove their case in the pleadings.

More troubling is the fact the appeals court accepted the company's nonsensical explanation for the dividend cut and could not see the rather transparent relationship between the dividend cut the company's overstatement of its cash flow. The company's explanation is the equivalent to the Enron CEO denying there were undisclosed accounting issues that would explain Enron's declining stock price when it was later learned that Enron had been engaged in accounting fraud for sometime. n9-p19. In Robbins, the company's explanation for the dividend cut was a ruse to hide the fact that the company was fraudulently overstating its cash flow. Disagreement as to facts or the meaning of these facts in a pre-PSLRA case does not translate to a circuit court disagreement on pleading requirements in a PSLRA case.[11]

C. Petitioners' Arguments Against The Ninth Circuit's Price Inflation Standard For Pleading Loss Causation Are Duplicitous And Disingenuous

Petitioner and their amici wrongly presume that securities fraud pleadings that allege artificial inflation can not show that investors have been damaged absent a revelation of the truth followed by a corrective stock price decline. Petitioners' argue that pleading artificial inflation alone is inadequate to establish loss causation because investors' losses cannot be presumed to occur at the time of the transaction. Petitioners conclude that loss causation can only be pled in cases where the truth is revealed in a corrective disclosure.

Petitioner's otherwise sound arguments ignore the fact that securities fraud suits are not initiated when investors are blissfully enjoying paper profits of an artificially inflated stock price. Rather securities fraud suits are initiated after a significant drop in stock price after the alleged artificial price appreciation has been lost . The Dura suit, for example, was filed shortly after Dura stock dropped 47% in one day that was preceded by 20% decline in the prior three months. app.54a. Enron stock had declined by 50% in five months before the unexpected resignation of a new CEO caused its stock to drop another 16%. A1.

Securities suits are initiated after the artificial appreciation caused by allegedly false statements is lost. Pleadings of loss causation based on artificial price inflation can cite these

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[11] The Robbins appeal was decided shortly after the enactment PSLRA. The overturning of a jury verdict by an appeals court reinterpreting facts shows that in the post PSLRA period that circuit courts were leaning over backwards to dismiss the presumed meritless cases that PSLRA sought to eliminate. After Enron, in the shadow of an unprecedented wave of real accounting fraud, courts have and should judge with a more balanced view. Judge Easterbrook's opinion in Asher v. Baxter Int'l Inc., 377 F. 3d 727 (7th Cir. 2004) shows the new reality. Cf. n5, 7-8.

stock price declines as eliminating the artificial price inflation caused by the defendant's false and misleading statements. Investors do not have to prove loss causation in their pleadings. No one can say before evidence is introduced, whether a stated reason for a stock decline is really the truth (particularly when provided by defendants accused of fraud). Compare this with Judge Easterbrook's current reasoning on a related PSLRA issue.

> [A]ny particular caution, which always may be challenged as not sufficiently 'meaningful' or not pinning down the 'important factors that could cause actual results to differ materially." Asher v. Baxter Int'l Inc., 377 F. 3d 727 729 (7th Cir. 2004).
>
> ...
>
> Baxter's chosen language may fall short. There is no reason to think... at the pleading stage, before plaintiffs have access to discovery – that the items mentioned in Baxter's cautionary language were those thought at the time to be the 'important' sources of variance. Id. 734. Cf. n.5 7-8.

In 34 Act cases, the magnitude of the stock decline preceding the filing of a securities class action is often an anomalous departure from historic trading patterns and belies the publicly disclosed information. In the absence of a "corrective disclosure" such price action can be cited in the pleadings to show a reduction in the artificial inflation and satisfy the loss causation standards. (Please see D on p. 26.)

Amicus Securities Industry Association (SIA) disingenuously argues that the artificial price inflation standard is inconsistent with statutory language of the 33 Act. According to the SIA, an actionable loss in 33 Act cases is "*the depreciation in value*" resulting from untrue or omitted statements from the prospectus. SIA Br. p.16. SIA asserts that this language forecloses a reduction in artificial price appreciation by an unspeci-

fied albeit anomalous stock price decline and that this interpretation would also apply to 34 Act cases.

However, 33 Act cases and companies are easily distinguished from 34 Act cases and companies and the SIA's use of the statutory language of the 33 Act to interpret the 34 Act is really disingenuous. 33 Act companies are recently private companies often in new industries with innovative products which are raising public capital for the first time. Most are unprofitable with little or no revenue. The valuation metrics investors use to value 33 Act stocks is as new and varied as their products. Information provided investors about the business of these companies is tightly regulated and vetted by the underwriter and the SEC. 33 Act stock prices are volatile after their introduction to the public market. Eventually most of these companies fail or merge with stock prices declining substantially from the offering price.

Using language from the 33 Act to interpret the 34 Act may seem valid. However, the high volatility and expected stock declines of the typical 33 Act company that may justify strict statutory loss causation pleading requirements for these companies are not found in 34 Act companies with longer trading histories and lower price volatility. For mature profitable companies with established trading histories a sudden 47% price drop – on negative but hardly catastrophic news as seen in Dura – is both strong evidence that the prior trading range was artificially inflated and for pleading loss causation.

Amicus ML continues, urging "*rigorous loss causation standards*" to weed out hundreds of post-bubble meritless cases. ML Br. 18-24. ML cites the record 503 private federal securities law class action suits filed in 2001. The Securities Class Action Clearinghouse, however, classifies 176 of these cases as "classic" securities fraud (34 Act) with the remaining 65% being IPO and Analyst cases (33 Act).[12] Loss causation

arguments based on 33 Act cases are not relevant to 34 Act cases such as Dura. Specifically, it is not appropriate to cite the 33 Act, Bastian v. Petren Resources Corp., 892 F. 2d 680 (7th Cir.), cert. denied, 496 U.S. 906, to argue that without restrictive loss causation standards "*Section 10(b) would be an uncompensated insurance mechanism covering losses attributable to events other than defendant's fraud. …Speculators in a risky market could effectively transfer the risk of bad investments to issuers…*" ML Br. 9.

The Petitioner also cites Bastian – "*No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation.*" Id. 686 – to support its argument that the "*Ninth Circuit's price-inflation theory of loss causation, … is revolutionary and would radically alter … how loss causation has been applied in most circuits…*" Pet. Br. 26. Petitioner's reliance on the cited language is even more ridiculous considering it is merely dicta speculating on the reason for the investment loss. More telling for the argument here, Judge Posner acknowledged that loss causation could be established in the face of the unanticipated change in business conditions.

> Perhaps if the plaintiffs had conducted [research] they would have discovered, contrary to our speculation (and it is just that), that oil land gas ventures managed by competent and honest businessmen *had* survived the drop in oil prices. If so, this would support an inference that if the defendants had been as competent and honest as they represented themselves to be, they would not have lost the plaintiffs' $600,000. Id. 684

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[12] Stanford Law School Securities Class Action Clearing House, http://www.securities.stanford.edu/2001

This language suggests that the Ninth Circuit's price inflation theory is not revolutionary but is in fact consistent with how loss causation is applied in other circuits.

Amicus Chamber of Commerce cites Bastian as a Seventh Circuit decision that conflicts with the Ninth Circuit. Chamber 3. The Chamber also cites Bastian at 685 as its sole support to wildly speculate that the "*Ninth Circuit's rule … will also serve to chill investment advice and reporting and the free flow of information in our capital markets.*" Chamber 16. Bastian is a 33 Act case, an oil & gas limited partnership sold at the last peak in oil prices that was apparently organized by "fly by night" promoters who misrepresented their expertise in the offering memoranda. The securities never traded in a market and contrary to assertions by the petitioners and their amici would not even meet the Ninth Circuit's artificial price inflation loss causation standard that requires investors bid up the price of a security in response to false and misleading disclosures. Arguments to the contrary are disingenuous and duplicitous. [13]

ML, Chamber, and SIA concerns about frivolous class action suits and "blackmail settlements" would be more appropriately addressed upon the granting of a writ of certiorari in Nice Systems, case no. 03-1676. Proscribing aggregate damage settlements as argued in the NICE petition, would eliminate the incentive for lawyers to file low merit suits.

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[13] Petitioners and their amici cite at least one other 33 Act case in arguing against the application of the Ninth Circuit's price appreciation standard in Dura, a 34 Act company. Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc. 343 F. 3d 189 (2nd Cir. 2003) is a private placement. The Chamber cites Emergent as a Second Circuit conflict with the Ninth. Chamber Br 3 n.4. (Cf. Pet. Br. 29; Technology Network Br. 3,4 & ML Br. 9) This amicus' review did not examine all the cases cited nor other amici briefs that are not cited.

Reducing the number of suits filed would reduce the burden on the courts in distinguishing low merit suits.

D. Although The Ninth Circuit's Presumption Justifying Its Loss Causation Standard Is Incorrect; An Alternative Presumption Justifies Its Standard And Reconciles It With *Basic* And The Other Circuits

The Ninth Circuit's artificial price inflation loss causation model presumes that an investor's loss "*occurs at the time of the transaction*," when he is harmed by paying too much, and a causal connection exists because it is the misrepresentation that inflated the price. (SEC Br. 21 quoting the opinion.) The SEC then argues that this view is mistaken because "*a purchase-time value disparity, standing alone, cannot satisfy the loss causation pleading requirement.*" Id. 21 citing Emergent, 343 F.3d at 198. Disregarding that Emergent is a private placement that should have no relevance to fraud-on-the market disclosures, there is an alternative presumption that justifies the Ninth Circuit standard. The new presumption would also bring the standard into conformance with Basic Inc. v. Levinson, 485 U.S. 224 (1988) and standards other circuits have applied in 34Act cases.

The Ninth Circuit could just as easily have justified its loss causation standard by presuming that the investor's loss from purchasing an artificially inflated stock does not occur at the time of purchase but later following an anomalously large decline in market value of a stock. That decline could be triggered by a purportedly exogenous disclosure or no disclosure at all. Real fraud-on-the-market cases like Enron and WorldCom involve subtle manipulation of earnings to show quarter to quarter increases that investors favor with a premium valuation as expressed by the price-earnings ratio (P/E ratio). Then, for example, if a company perpetrating a fraud discloses a business reversal unrelated to the fraud, the drop in stock price will at

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st in part be due to a reduction in the premium P/E that was
ised by the alleged fraud. The reduction in the P/E ratio then
uld reduce the artificial inflation. Thus in pleadings alleging
ificial inflation, loss causation is established by any anoma-
s decline as the market can no longer justify the premium P/E
io created by the fraud.

An anomalous decline, for example, could be one that is
usually large when compared to a particular stock's trading
tory or that of its industry index. Dura's 47% one day
cline was by far the largest in a six year trading history.
p. 54a. A decline also could be anomalous if, for example,
was out of proportion to the concurrent disclosure. Market
dence might show, for example, that Dura's 47% decline
s anomalous in light of its disclosure that the rate of
rease of its Ceclor CD sales for 1998 would be one half
analysts expectations and the lower growth would be
ieved only after the company added more sales people. [14]
erck's stock, for example, only declined by 27% on the
nouncement it would withdraw VIOX with $2.5 billion in
nual sales because of an increased risk of heart attacks. [15]

The alternative price inflation model is nicely supported
he legislative history of the PSLRA as noted in the SEC's
f at 26. The House and Senate Conference Committees'
nference Report explaining loss causation provides an

[14] 1998 Dura's announcement of slower Ceclor CD sales expectations in 1998 is consistent with the complaint's allegations that it overstated 1997 sales by "stuffing" the distribution channel. By not making a corrective disclosure, Dura hopes to avoid liability for fraud. Because companies committing securities fraud rarely disclose their frauds; flexible loss causation standards are required to prevent dismissal of meritorious cases.

[15] Simons & Stipp, *Merck's $27 Billion Heart Attack Lawyers are circling, Wall Street is howling. Can the proud drug giant survive the Vioxx mess?* Fortune Nov. 1, 2004

example that states: "*the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission.*" SEC Br. citing H.R. Conf. Rep. No. 369 at 41 and S. Rep. No. 98 at 15. The SEC notes that these reports support the Ninth Circuit's standard but then disregards the reports because of the Ninth Circuit's erroneous presumption that shareholders are damaged at the time of purchase. The alternative presumption that shareholders are damaged by an anomalous price decline subsequent to purchase ties in nicely with the Conference Report.

CONCLUSION

The judgment of the court of appeals should be affirmed.

November, 2004

Respectfully Submitted,

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APPENDIX

CHRONOLOGY OF ENRON'S ANOMALOUS STOCK PRICE DECLINE

8/17/01 - Enron Stock Slide Continues;

Enron stock closed more than 8% lower, to close at **$36.85/share**. The value has declined almost $6/share in the past two days, following the announcement late Tuesday that Jeff Skilling, the chief executive since February, had resigned.

Last summer, Enron shares hit their highest ever price at $90.75/share and still were trading at around $80 when Skilling assumed the top position…

A slew of factors contributed to the market's loss of confidence in Enron and the accompanying slide in stock value. Its once-vaunted broadband business is losing large sums of money and has never recovered from the loss of a movie-on-demand deal with Blockbuster Video in March. The Dabhol Power project, at one time the prize example of foreign investment in India, has turned into a debacle and now is for sale.

Compounding the situation was last week's explosion at the Teesside power plant in the UK and the loss of three workers (OD Aug.9, p2). The company mysteriously withdrew from two high profile Middle East gas ventures, including a stake in one of three Saudi Arabian gas openings. California's attorney general has issued virtual "wanted posters" for the company and its execs for allegedly causing the state's electricity crisis. Finally, the New Power retail electricity joint venture with America Online and IBM is not progressing as fast as expected. The Oil Daily. (OD)

8/24/01 – Q & A Interview with Lay

Q. There has been some concern among investors that… perhaps accounting or other issues that have yet come to light. Is there anything more?

A. There are absolutely no problems that had anything to do with Jeff's departure. There are no accounting issues, no trading issues, no reserve issues, no previously unknown problem issues. The company is probably in the strongest and best shape that it has ever been in. Business Week Online.

9/7/01 – Enron Stock Continues to Fall;

The stock closed at **$30.49** down almost $12/share since former Chief Executive Jeff Skilling resigned on Aug. 14.

Analysts contacted by Oil Daily were at a loss to explain the continued decline in the absence of specific news. OD.

9/19/01 – Enron Stock Thrashed Over Disclosure…;

Beating up on Enron's common stock has become an almost regular event on Wall Street, but Thursday's thrashing was particularly brutal as the price slid $3.20, or almost 10%, to **$29/share** in heavy trading.

The reason was investors' unhappiness over Enron's failure to disclose adequately a $1.2 billion charge to equity included in the third-quarter financial results released earlier this week (OD Oct.17,p1).

Thursday's decline came on top of $1.64 drop on Wednesday, when more details of a terminated joint venture arrangement between Enron and a limited partnership headed by its Chief Financial Officer Andrew Fastow. OD.

10/24/01 – Enron Chief Fails to Stem Stock Slide;

Enron closed at **$19.79**. Enron executives tried to affirm that all was well in the core businesses… and to steer the inquiries away from financial obligations and corporate credit worthiness. Lay denied that Enron is concealing any material information. OD.

10/31/01 – Takeover Talk Can't Halt Enron Stock Plunge;

Enron shares fell $2.65 to close at **$11.16/share** in spite of reports that either BP, General Electric, or Royal Dutch/ Shell was about to make a bid for the battered natural gas and power trading giant.

Enron stock has fallen more than 60% since third-quarter financial results showing a $1 billion asset write down, a $632 million net loss, and a $1.2 billion charge to equity were disclosed two weeks ago… Investors and analysts were livid that Enron had not honored its pledge to be more open and transparent about its financials. OD.

11/12/01 – Dynegy Seals Deal to Acquire Enron

The agreement calls for each share of Enron stock to be exchanged for just under 0.27 shares of Dynegy, or about $10.41 for each Enron share. Enron stock, which traded as high as $90.75 in August 2001, closed Friday at **$8.63**, up a mere 22[cent] on the day. Dynegy ended at $38.76, up $2.26. OD.

11/21/01 – Enron Stock Plunges on Credit Concerns;

Enron shares stood at **$6.99/share** – or about 39% below Dynegy's bid price of $11.60/share – spurring fears that the deal may fall through.

"Although Enron's recent disclosures help shed light on the true financial condition of the firm, the disclosures continue to be piecemeal and it appears that the full extent of Enron's problems is not currently known, ...[The company] remains in a precarious financial position and its status as a going concern is much in doubt." OD. quoting Commerzbank securities analyst Andre Meade.

11/26/01 – Enron Share Price Dives;

[I]nvestors remained concerned as to whether the company can stay afloat long enough to complete its merger with rival Dynegy.

Those concerns deepened as Enron's stock price slumped by 28% on Wednesday – to barely **$5** – on top of a 23% drop the previous day. Analysts said the firm could be forced into bankruptcy if the deal with Dynegy were to fall through as a result. OD.

11/29/01 – Enron Bankruptcy Likely as Dynegy Walks;

Dynegy, Enron's last good hope for a rescue from its financial failings, walked away from the proposed acquisition Wednesday, leaving the once-mighty natural gas and power trading company with no option but the bankruptcy court.

...

The deal killer in this corporate drama came mid-morning Wednesday when credit agency Standard and Poor's cut Enron's rating to junk status. Moody's Investors Service and Fitch quickly followed. This accelerated massive debt repayment obligations.

...

Enron's already depressed common stock lost almost all its remaining value. It fell to **60[cent]** at one point from Tuesday's close of $4.11. OD.

Supreme Court, U.S.
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No. 03-932

In the Supreme Court of the United States

DURA PHARMACEUTICALS, INC., ET AL.,

Petitioners,

v.

MICHAEL BROUDO, ET AL.,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR MERRILL LYNCH & CO., INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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QUESTION PRESENTED

Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving in a reliable and non-speculative manner that the defendant's fraud actually caused the plaintiff injury.

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INTEREST OF THE AMICUS CURIAE

Merrill Lynch & Co., Inc. ("Merrill Lynch") is a diversified financial services company with 48,000 employees worldwide.[1] Merrill Lynch provides corporations, financial institutions, and governments with investment banking and advisory services, including underwriting new securities offerings. It also provides wealth management services, including retail brokerage, to more than a million clients. Merrill Lynch furnishes research and analysis concerning individual securities, prepared both by employee analysts and by third parties.

Like other financial services companies, Merrill Lynch is subject to federal class action suits brought by investors whose investments have not performed as they had hoped. Such suits, which mushroomed prior to passage of the Private Securities Litigation Reform Act in 1995, dipped temporarily thereafter. In 2000, however, a huge stock market "bubble" burst, causing trillions of dollars in market losses within a matter of months. The events that precipitated the collapse of the bubble also bankrupted or slashed the value of many issuers of securities, particularly internet and technology companies, diminishing prospects for recovering damages from them. Investors therefore turned their sights on the securities industry. They filed hundreds of class action securities fraud suits against firms that served as underwriters for issuers' stock offerings and that employed research analysts who offered opinions on the securities. Plaintiffs magnified the threat these suits posed by seeking certification of long class periods and

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[1] Pursuant to Rule 37.6, Merrill Lynch states that no counsel for a party authored this brief in whole or in part and that no person or entity other than Merrill Lynch made a monetary contribution to its preparation. The consents of the parties to the submission of this brief have been filed with the Clerk.

classes encompassing anyone anywhere in the world who purchased the stock.

Merrill Lynch is a defendant in a number of these suits. It is vitally interested in the question presented in this case, which affects how easily Section 10(b) suits can survive motions to dismiss or be certified as class actions and what must be proved at trial to establish liability. A permissive loss causation standard like that adopted by the Ninth Circuit threatens to make issuers and their advisers, and even the analysts who opine on a company's prospects, insurers against market fluctuations attributable to other events, including seismic shifts across broad markets like the bursting of the 1998-2000 stock market bubble. In an area where the threat of huge liabilities exerts so powerful a pressure to settle that few cases ever reach trial it is particularly important that the loss causation standard be rigorous enough to weed out meritless suits at the early stages of litigation.

Merrill Lynch believes that its experience with post-bubble suits and as a leading financial services company gives it a perspective that will be useful to the Court in considering the meaning of the loss causation requirement.

SUMMARY OF ARGUMENT

The Ninth Circuit's lax causation standard invites the abusive litigation and coerced windfall settlements that Congress in the Private Securities Litigation Reform Act sought to forestall. Weak causation rules arbitrarily reward speculators instead of compensating those truly injured by fraud, harm investors by increasing costs, create perverse disclosure incentives, and undermine the efficient operation of capital markets. To effectuate the goals of the Securities Exchange Act and PSLRA, this Court should insist on a more rigorous standard that screens out

speculative theories of causation and requires a plaintiff to show that defendant's misconduct actually and directly caused plaintiff's loss. In this case, that would require that plaintiffs plead and prove not only that Dura's allegedly misleading statements inflated the price of Dura's stock, but also that revelation of the truth resulted in a decline in price that can reliably be traced to the misstatement to the exclusion of other factors.

That standard serves the goals of the securities laws. It enables investors to obtain compensation for injuries caused by fraud, allows innocent defendants to dispose of meritless suits prior to trial and resist unwarranted class certification, and removes a serious impediment to the free flow of information in securities markets.

The hundreds of Section 10(b) class actions filed since the stock market bubble burst in 2000 demonstrate the need for this Court to adopt a rigorous loss causation standard. These suits seek to hold issuers, underwriters, and research analysts responsible for losses that investors incurred on risky stocks of unproven internet and high technology companies, which reached unprecedented highs on a wave of investor enthusiasm before losing most of their value within a few months. The Exchange Act and PSLRA require plaintiffs in these actions to trace their losses back to fraud by defendants and exclude both the effect of other forces driving the inflation and bursting of the bubble and company-specific factors that caused many investments to fail. Absent a rigorous loss causation standard, these class action suits threaten to seriously burden the federal district courts while chilling speech on subjects of importance to public investors.

The existence of numerous other civil, criminal, administrative and arbitral remedies, as well as practical incentives to truthful disclosure, ensure that a rigorous

causation standard will not detract from the deterrent and compensatory goals of the securities laws. The Solicitor General and SEC properly recognize that the Ninth Circuit's lax causation standard is not an appropriate means to supplement government enforcement.

ARGUMENT

I. PLAINTIFFS IN PRIVATE SECTION 10(b) DAMAGES SUITS MUST PLEAD AND PROVE IN A NON-SPECULATIVE MANNER THAT DEFENDANT'S FRAUD CAUSED PLAINTIFFS' INJURIES.

During an "'ebullient' stage" in the development of implied causes of action, this Court found an implied cause of action under Section 10(b) even though there is no indication Congress "considered the question of private civil remedies" when it enacted this antifraud provision. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 729-730 (1975); LOSS & SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1025 (3d ed. 1995). To prevent that judicially implied right of action from resulting in "'liability in an indeterminate amount for an indeterminate time to an indeterminate class'" (*Blue Chip Stamps*, 421 U.S. at 748, quoting *Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 174 (1931)), this Court has repeatedly "narrow[ed] Rule 10b-5 as a matter of substantive coverage." LOSS & SELIGMAN, *supra*, at 1036, 1050.

As the Court explained in *Blue Chip Stamps*, it has pruned this "judicial oak" grown from a "legislative acorn" "as a matter of policy." 421 U.S. at 735, 737-739. It has rejected "expansive imposition of civil liability" under Section 10(b) because the implied cause of action "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."

Id. at 739-740. In particular, the Court has recognized that, because of the risk of a jury verdict holding defendant liable for huge market losses, "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success" if the plaintiff is able to "prevent the suit from being resolved against him by dismissal or summary judgment." And the threat of costly and disruptive discovery adds a further "*in terrorem* increment" to the settlement value of a suit. *Id.* at 740-741.

This Court has therefore repeatedly limited the scope of private securities damages actions to curtail their coercive potential and make meritless claims easier "'to dispose of before trial.'" *Blue Chip Stamps*, 421 U.S. at 742-743. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (requiring proof of scienter, not mere negligence); *TSC Indus.* v. *Northway, Inc.*, 426 U.S. 438 (1976) (rejecting lax definition of materiality); *Santa Fe Indus.* v. *Green*, 430 U.S. 462 (1977) (limiting Section 10(b) to manipulative or deceptive conduct); *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985) (confining Section 14(e) to manipulative acts that involve misrepresentation or nondisclosure); *Central Bank* v. *First Interstate Bank*, 511 U.S. 164, 189 (1994) (rejecting aiding and abetting claims under Section 10(b) because they would engender "uncertainty and excessive litigation").

Despite these and other judicially imposed limitations, empirical studies showed that "[f]or practical purposes, the merits do not matter" in Section 10(b) class actions. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 501 (1991) (Section 10(b) became "a grotesquely inefficient form of insurance against large stock market losses" that "encourages the filing of more and weaker suits"). Bet-the-

company damages claims and huge litigation costs forced defendants into settlements that were neither "voluntary," because the risks mean that trial was not "a practically available alternative," nor "accurate," because "the strength of the case on the merits has little or nothing to do with determining the amount of the settlement." *Id.* at 499; accord Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991).

Responding to "significant evidence of abuse" that undermined "American capital markets" and caused "serious injuries to innocent parties" who were "forced to pay exorbitant 'settlements,'" Congress passed the Private Securities Litigation Reform Act ("PSLRA") "to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." H.R. Conf. Rep. No. 104-369, at 31-32 (1995) ("H.R. Conf. Rep."). The PSLRA prescribes an express "loss causation" standard, stays costly discovery pending ruling on motions to dismiss, establishes a safe harbor for forward-looking statements, and imposes other procedural and substantive limits to curtail abusive Section 10(b) class suits.

Nevertheless, respondents urge and the Ninth Circuit adopted a causation standard that moves headlong in the opposite direction, significantly easing plaintiffs' burden and encouraging abusive strike suits. Both Congress in the PSLRA and this Court have identified such lax causation rules as a particular concern and have insisted that plaintiffs show in a non-speculative manner that defendant's misconduct actually caused plaintiffs' losses.

A. Section 10(b) Claimants May Not Rely On Speculative Theories Of Causation But Must Plead And Prove That Defendant's Misconduct Actually Caused Them Injury.

Congress in the Exchange Act established the general principle that an investor may not recover an "amount in excess of his *actual* damages *on account of*" a violation of the securities laws. 15 U.S.C. § 78bb(a) (emphasis added). After years of experience with abusive Section 10(b) damages actions based on speculative causation theories, Congress expressly provided in the PSLRA that a private Section 10(b) "plaintiff shall have the burden of proving that the act or omission of the defendant * * * *caused* the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4) (emphasis added). The language of these provisions on its face requires a plaintiff "to plead and then to prove," without speculation, that defendant's act or omission caused a loss to plaintiff. H.R. Conf. Rep. at 41. This standard is not satisfied by mere allegation or evidence that defendant's conduct inflated the price of a security when plaintiff purchased it, for such inflation may or may not eventually result in actual injury directly traceable to defendant's illegal act or omission.

In adopting the PSLRA Congress recognized that Section 10(b) class actions are filed and settlements coerced whenever "a company's stock moves significantly, up or down." H.R. Rep. No. 104-50, at 16 (1995) ("H.R. Rep."). Such movements occur for many reasons. They do not by themselves show that a plaintiff's loss is due to defendant's misconduct. Accordingly, Congress sought to ensure "that plaintiffs prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors." S. Rep. No. 104-98, at 7 (1995) ("S. Rep."); see *Hearings before the Subcmte. on Securities of*

the Cmte. on Banking, Housing and Urban Affairs, S. Hrg. No. 103-431, at 568 (1993) ("market loss" difference between "purchase price" and "sale price" of stock does not identify "losses caused by fraud") (testimony of Patricia Reilly). Simply proving inflation at the time of plaintiff's purchase does not establish that defendant's wrongful conduct resulted in plaintiff's loss.

Congress's refusal to allow damages actions to proceed on the basis of speculative and indeterminate damages theories reflects principles previously announced by this Court. A series of decisions insisted on rules that avoid "throw[ing] open to the trier of fact * * * hazy issues of historical fact" about causation, and that "permi[t] exclusion prior to trial" of a Section 10(b) plaintiff who cannot prove "in a readily demonstrable manner" that an alleged fraud "damaged him." *Blue Chip Stamps*, 421 U.S. at 742-743, 746. See also *id.* at 734-735 (limiting Section 10(b) action to purchasers and sellers of securities because causation of injury to others would be "conjectural and speculative"); *Virginia Bankshares* v. *Sandberg*, 501 U.S. 1083, 1105-1106 (1991) (refusing to extend Section 14(a) private damages action to shareholders whose proxy was unnecessary to approval of a transaction to avoid "speculative claims" in which "[c]ausation would turn on inferences" that would be "hazy" and "unreliable"); *Dirks* v. *SEC*, 463 U.S. 646, 667 n.27 (1983) (declining to give weight to claims of "shareholder 'losses,' 'injury,' and 'damages'" where there was "no clear causal connection between inside trading and outsiders' losses"); *Santa Fe*, 430 U.S. at 474 n.14 (non-disclosure not actionable where plaintiffs "do not indicate how they might have acted differently had they had prior notice of the merger"). These precedents preclude recovery of losses that are "indirec[t]," "too remote," or speculative. *Holmes* v. *SIPC*, 503 U.S. 258, 268-269 (1992).

Consistent with these precedents, courts of appeals typically require proof that a defendant's misconduct determined the security's ultimate performance ("loss causation")—not merely that it induced plaintiff's purchase or sale of the security ("transaction causation"). *E.g.*, *Emergent Capital Inv. Mgmt.* v. *Stonepath Group*, 343 F.3d 189, 198 (2d Cir. 2003) (allegation that defendant's misconduct inflated the price of a stock is "a paraphrased allegation of transaction causation," which "may explain why plaintiff purchased" the stock but not "why it lost money on the purchase"); *First Nationwide Bank* v. *Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994) (properly dismissed complaint did not allege that misstatements were "the reason the transaction turned out to be a losing one"); *Robbins* v. *Koger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997).

Without these limitations, Section 10(b) would be an uncompensated insurance mechanism covering losses attributable to events other than defendant's fraud. See *Bastian* v. *Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir. 1990) (Posner, J.) ("Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities" or "industry-wide phenomena"). Speculators in a risky market could effectively transfer the risk of bad investments to issuers and market professionals, even though, if those losses would have occurred regardless of any fraud, "any award of damages to them would be a windfall." *Id.* at 684-685.

"No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda," press releases, and analyst reports "in the hope of uncovering a misrepresentation." *Id.* at

685. Section 10(b) plaintiffs must plead and prove that the value of their securities fell "because of the misrepresented financial condition," not "as a result of some subsequent event." *Citibank* v. *K-H Corp.*, 968 F.2d 1489, 1496 (2d Cir. 1992). See *Moore* v. *PaineWebber*, 189 F.3d 165, 172 (2d Cir. 1999) (no liability for losses attributable to "intervening" or "extraneous" causes); *id.* at 177 (Calabresi, J., concurring) (purchase "as a result of fraud does not suffice to show loss causation when the whole market collapses"); *First Nationwide*, 27 F.3d at 769-770 ("when factors other than the defendant's fraud are an intervening direct cause of a plaintiff's injury, that same injury cannot be said to have occurred by reason of the defendant's actions"); *Bastian*, 892 F.2d at 684 (securities lost value because of market collapse, not risks concealed by defendant); H.R. Conf. Rep. at 42 (Section 10(b) damages limited to "losses caused by the fraud and not by other market factors").

In a case like this one, in which Dura is alleged to have made misleading statements concerning its business, these principles require that the plaintiff allege and prove a distinct inflation in stock price caused by defendant's conduct, and then a distinct deflation in price upon revelation of the truth that is directly linked to the defendant's false statements and is not explained by other events. Plaintiffs concededly have not so pled. In a manipulation case, the same principles require the plaintiff to show distinct inflation in a security's price caused by market manipulation, followed by a decline when the manipulation ceased that can be directly traced to cessation of defendant's misconduct rather than some other event. A less objective causation standard would be too easy to circumvent, thereby subverting Congress's goal of disposing of meritless Section 10(b) cases at the dismissal stage. S. Rep. at 7.

Any lesser showing would prove not that defendant's wrong caused plaintiff's loss, only that it might have done so. In particular, the "foreseeability" test used by some courts to address issues of proximate cause is poorly adapted to transactions in modern securities markets in which "[s]o many forces operate in the market for an active security that there is little certainty in identifying causes or measuring their separate effects." 4 BROMBERG & LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 7:498, at 7-985 to 7-986 (2d ed. 2004); see also 9 LOSS & SELIGMAN, SECURITIES REGULATION 4280-4281 (rev. 3d ed. 2004) ("With all the factors that determine stock market prices," any "lingering effects" of a fraud soon "become intermingled with many other market determinants").

A requirement that a Section 10(b) damages plaintiff allege and prove merely that its loss was "foreseeable"—rather than that it was directly caused by defendant's conduct—would encourage suits based on uncabined speculation, make impossible the early disposal of meritless suits, and give rise to the very abuses identified in *Blue Chip Stamps* and by Congress in adopting the PSLRA. See *Fogarazzo* v. *Lehman Bros.*, 2004 WL 1151542, at *11, *14 (S.D.N.Y. 2004) (refusing to dismiss Section 10(b) claim that analyst reports caused plaintiffs' losses after bubble burst on ground that it was "foreseeable" that market would ignore publicly known facts about issuer's dire financial condition because analysts were "optimistic"). Mere speculation that defendants may have caused investment losses is not enough to warrant giving plaintiffs the tools to extract massive settlements that, we show in the next section, undermine the investor-protective goals of federal securities legislation.

B. Permitting Section 10(b) Class Actions To Proceed On The Basis Of Speculative Theories Of Causation Would Do "More Harm Than Good."

"'[C]ourts must look to the underlying policies or legislative intent in order to draw a manageable line between those causal changes that may make an actor responsible for an effect and those that do not.'" *Dep't of Transp.* v. *Public Citizen*, 124 S. Ct. 2204, 2215 (2004); see *Blue Chip Stamps*, 421 U.S. at 735. Given Congress's aim in the PSLRA to enable "defrauded investors [to] recover their losses," while simultaneously preventing "abusive and meritless suits" that result in "serious injuries to innocent parties," "the investing public and the entire U.S. economy," the proper causation rule should require plaintiff to trace a measurable loss to defendant's wrongful conduct and allow defendants to obtain dismissal of claims that rest on speculative theories that cannot reliably support that showing. H.R. Conf. Rep. at 31.

Permissive causation rules requiring merely a causal link to price inflation but not to a plaintiff's loss would turn Section 10(b) into an uncompensated insurance scheme for speculators in high-risk stocks (and a rich harvest of fees for their lawyers), and would do "'more harm than good.'" *Hochfelder*, 425 U.S. at 214 n.33, quoting *Blue Chip Stamps*, 421 U.S. at 747-748. Because such rules result in compensation for market losses that are not reliably tied back to a defendant's misleading statement, they do not serve Congress's goal of compensating an investor for no more than his "actual damages" "caused" by the wrong.

Every delayed announcement of accurate firm information produces both winners (who sold during the period of inflation) and losers (who bought then and sold

after disclosure of the truth). POSNER, ECONOMIC ANALYSIS OF LAW 489 (5th ed. 1998). "Over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time" and will not benefit from "a legal rule that forces his winning self to compensate his losing self over and over." EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 340 (1991); see Winter, *On 'Protecting the Ordinary Investor'*, 63 WASH. L. REV. 881, 884 (1988) (describing ways in which diversification reduces risks to ordinary investors).

This balance of benefits and harms was pronounced during the bubble, when a high proportion of those buying and selling technology stocks were short term day-traders interested solely in movement in a stock's price over a few minutes or hours and not in the accuracy of information about a company or the integrity of its stock price as a reflection of the company's value. See SEC, DAY TRADING: YOUR DOLLARS AT RISK (Mar. 2, 2001); SEC, SPECIAL STUDY: REPORT OF EXAMINATIONS OF DAY-TRADING BROKER-DEALERS (Feb. 25, 2000); PERKINS & PERKINS, THE INTERNET BUBBLE 25 (1999). Momentum traders, though they might hold a stock longer than day-traders, similarly sought to take advantage of fluctuating price movements, aiming to sell before upward momentum ran out. See DEVITTO, IRRATIONAL MARKETS AND THE ILLUSION OF PROSPERITY 108 (2001) ("Momentum" investors "simply identify stocks with the greatest upward momentum and buy them"; "value or worth of a company is not a consideration"). These speculators traded the stock of a single company many times. Sometimes they benefited from delays in the dissemination of truthful information; sometimes they lost. Obviously, it would be unavailing to try to demonstrate loss causation simply by pointing to "price inflation" at the time such traders purchased stock.

The arbitrary provision of compensation to some investors for market losses that may or may not have been caused by defendant's conduct results in the very problem of abusive litigation and coerced settlements that Congress identified in the PSLRA. See, *e.g.*, Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 949-950 (1993) (stock transactions result in "litigation whenever investors have lost an amount sufficient to support an award of attorney's fees"; in one industry, a class action was filed to challenge *every* IPO where the stock traded below the IPO price after 15 months). This may be beneficial for lawyers and expert witnesses, but it is manifestly injurious to investors.

These suits "extract a deadweight loss from investors." *Id.* at 952. Continuing stockholders are harmed when the issuer incurs litigation costs and pays a massive settlement compensating some shareholders and their lawyers. See H.R. Conf. Rep. at 32 ("Investors always are the ultimate losers when extortionate 'settlements' are extracted from issuers"); S. Rep. at 9 ("long-term investors ultimately end up paying the costs associated with the lawsuits"); FRIENDLY, FEDERAL JURISDICTION 120 (1973). They are harmed too when investment banks and other professionals that are essential to raising capital and the efficient working of the market are subjected to open-ended Section 10(b) damages suits. Defending those suits drives up the cost of professional services and makes professionals unwilling to serve newer and smaller companies. *Central Bank*, 511 U.S. at 189, citing Winter, *supra*; see H.R. Rep. at 20 ("Fear of litigation keeps companies out of the capital markets," and "businesses suffer as auditors and directors decline engagements and board positions"); Alexander, *supra*, 43 STAN. L. REV. at 570-573.

Lax causation rules also disserve the core goal of the securities laws to ensure the free flow of information that is critical to investors and to market efficiency. H.R. Conf. Rep. at 42 ("Abusive litigation severely affects the willingness of corporate managers to disclose information to the marketplace"). A firm that discloses information "inevitably takes the risk of excessive optimism and excessive pessimism." EASTERBROOK & FISCHEL, *supra*, at 339. A "rule penalizing excesses in either direction would lead to silence" about a company's prospects. *Ibid.*

Investors particularly "want the issuer's own view of its future." KRIPKE, THE SEC AND CORPORATE DISCLOSURE 25 (1979). Broad causation theories bring the threat of massive liabilities for such prognostications (see *Asher* v. *Baxter Int'l*, 377 F.3d 727 (7th Cir. 2004)), creating a potent disincentive to discuss the company's future. See Backman, *Forward-Looking Statements and Cautionary Language After the 1995 Reform Act*, in PLI, SAILING IN "SAFE HARBORS" 153, 158-159, 208-209 (1997). Corporate managers' communications with analysts, which are "necessary to the preservation of a healthy market," are also muzzled by the risk of Section 10(b) suits based on weak causal links. *Dirks*, 463 U.S. at 658-659; see SEC, Release No. 33-7881, 65 Fed. Reg. 51716, 51718 n.19 (2000) ("fear of legal liability" "chill[s]" communications with analysts). When SEC disclosure requirements do not make silence an option, issuers may respond to the threat of unconstrained liability with defensive disclosure that "bur[ies] the shareholders in an avalanche of trivial information." *TSC*, 426 U.S. at 448; see *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231 (1988).

Allowing Section 10(b) suits to proceed on the basis of speculative causation theories thus detracts from the quantity and quality of information received by investors.

Congress's goal in adopting more stringent limits on private damages actions in the PSLRA was to address the concern that Section 10(b) suits had "'chill[ed]" the "robustness and candor of disclosure.'" H.R. Conf. Rep. at 43; see H.R. Rep. at 19 ("abuse of the 10b-5 system * * * deters the voluntary disclosure of information that the Federal securities laws were designed to promote"); S. Rep. at 5. This Court has refused to interpret the Exchange Act in ways that undermine the free flow of information, and it should do so once again here. *Dirks*, 463 U.S. at 658-659.

Open-ended liabilities based on speculative causation theories also burden constitutionally protected speech. This Court should not expand implied private rights of action in a way that infringes on the First Amendment, especially with regard to expression in which there is such a strong public interest. See *Lowe* v. *SEC*, 472 U.S. 181, 210 & n.58 (1985) (there is "no doubt about the protected character" of "the expression of an opinion about a marketable security," "factual information about * * * market trends," and "commentary" on "market conditions"); *Nike, Inc.* v. *Kasky*, 539 U.S. 654, 664 (2003) (Stevens, J., concurring); *id.* at 676-678 (Breyer & O'Connor, JJ., dissenting). As the United States explained in its brief in *Nike*, the "First Amendment does not tolerate" a "private cause of action" for monetary relief against a company for "false statements respecting its products"—whether those statements "constitute 'commercial' or 'noncommercial'" or hybrid speech—because such "unconstrained" actions pose "a serious threat of unjustifiable chill to legitimate speech on matters of public interest" and to "the free flow of useful information." 2003 WL 899100, at *7-*8, *12, *20, *25. The United States pointed to the necessity of "constraining features" like rigorous standards of "actual" reliance and causation to

avoid an unconstitutional burden on speech. *Id.* at *20-*21, *23.

Furthermore, lax causation standards lead to "procedural intractibility" that imposes a considerable burden on the courts. *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351, 366 n.28 (S.D.N.Y. 2003) (Pollack, J.). Dissatisfied investors "would be able (with the benefit of hindsight) to point to any allegedly misleading positive statement issued by anyone (not just the issuer) and couple that with an allegation that the price of the security was inflated as a result to satisfy loss causation," which invites "self-serving testimony, strike suits and protracted discovery." *Ibid.* Because the "issues would be hazy," the "litigation protracted," and the "resolution unreliable," these class actions would be especially burdensome. *Ibid.* (quoting *Grace* v. *Rosenstock*, 228 F.3d 40, 48 (2d Cir. 2000)); Alexander, *supra*, 43 STAN. L. REV. at 572 (describing "cost to the public in judicial resources").

Given all these considerations, it is important in devising rules governing Section 10(b) damages actions to "reconcile the conflicting interests of investors in a manner designed to best protect the interests of *all* investors—those who are plaintiffs in a particular case, those who are investors in the defendant company, and those who invest in other companies" whose access to capital markets and professional advice would be curtailed by excessive liability risks. S. Rep. at 22. The lax causation rule plaintiffs advocate would skew the securities laws in favor of Section 10(b) plaintiffs, who may or may not have been injured by defendant's wrongful conduct, at the expense of investors in general. It also would undermine the efficient operation of capital markets and create perverse incentives that contradict the securities laws' goal of ensuring robust communication concerning issuers of securities. Plaintiffs'

causation standard, in short, has nothing to recommend it. See *Central Bank*, 511 U.S. at 188 ("Extending the 10b-5 cause of action * * * makes the civil remedy more far reaching, but it does not follow that the objectives of the statute are better served").[2]

A standard requiring particularized pleading and a reliable showing that defendant's wrong actually and directly caused a plaintiff's loss suffers from none of these defects. It achieves what Congress intended by "reduc[ing] significantly the filing of meritless securities lawsuits without hindering the ability of victims of fraud to pursue legitimate claims." H.R. Conf. Rep. at 39.

C. Hundreds Of Post-Bubble Section 10(b) Damages Actions Illustrate The Need For Rigorous Loss Causation Standards That Weed Out Meritless Cases At The Dismissal Or Class Certification Stages.

The federal courts today are congested with cases that clearly illustrate the danger of lax causation standards and the need to uphold the more rigorous pleading and proof requirements that Congress mandated in the PSLRA. Investors have filed hundreds of Section 10(b) damages suits in the aftermath of the stock market bubble to recover losses incurred on speculative investments in unproven internet and technology companies. A record 503 private

[2] These problems are compounded by the willingness of lower courts to ease plaintiffs' burden of proof by expanding the *Basic* presumption of causation and reliance to situations ever more remote from the issuer misstatements addressed in that case. See pp. 19-21, *infra*; see generally Oldham, *Taking "Efficient Markets" Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U. L. REV. 995 (2003).

federal securities law class action suits were filed in 2001, the year after the bubble burst. NERA, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2003 EARLY UPDATE 2 (Feb. 2004). These class actions exert irresistible pressure to settle. Securities fraud settlements totaled $6.6 billion in 2001-2003. CORNERSTONE, POST-REFORM ACT SECURITIES LAWSUITS 1 (2004).

These suits reach beyond issuers of securities. Congress recognized in adopting the PSLRA that "[u]nderwriters" and "other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant." S. Rep. at 9. When these "peripheral defendants are sued, the pressure to settle is overwhelming —regardless of the defendant's culpability." *Id.* at 21. Securities firms, which are perceived to have deep pockets and which inevitably are involved in some capacity in securities transactions, have been "prime targets" of post-bubble suits.

Plaintiffs, for example, have sued the underwriters of 309 bubble-era IPOs in class actions alleging that they misled investors about IPO allocation practices, principally alleged agreements that persons receiving IPO shares would purchase additional shares in the aftermarket. Those purchases supposedly inflated the price of the stock, in a gradually diminishing amount, throughout lengthy class periods that typically span the inflation and bursting of the bubble. *In re IPO Sec. Litig.*, No. 21 MC 92 (S.D.N.Y.). In addition, many suits have been filed against research analysts and their employers, alleging that analysts issued optimistic opinions they did not believe in order to protect their firms' investment banking work for the issuer, and that their opinions inflated the price of the stock during

some extended period. *E.g.*, *In re Merrill Lynch Research Reports Sec. Litig.*, No. 02 MDL 1484 (S.D.N.Y.).

The cost to settle such suits threatens to be enormous. One securities firm, which already has agreed to a multi-billion dollar settlement, has set aside reserves of nearly $10 billion to cover bubble-era securities fraud suits. Scannell & Pacelle, *Wall Street Gets Sticker Shock from Citigroup*, WALL ST. J., May 12, 2004, at C1. The *issuers* in the IPO suits, which are not plaintiffs' main target, have agreed to settle claims against them for $1 billion. Smith, *IPO Investors Get Assurance on Settlement*, WALL ST. J., June 27, 2003, at C1.

The causal assertions made in these cases are incredibly speculative and stretch beyond the breaking point the fraud-on-the-market theory adopted by a 4-2 plurality of this Court in *Basic*. Plaintiffs claim that a small number of open market "tie in" purchases of a security, made a few days after an IPO, inflated the price of the security and injured every purchaser throughout class periods of many months or years. They also contend that third party opinions, which are not alleged to have misstated facts about the issuer and which were circulated in a volatile market full of competing opinions, inflated the price of a security for long periods. But it is not a matter of "common sense and probability" to presume that limited aftermarket stock purchases or analyst opinions cause a lasting impact on stock price. No presumption of causation or reliance is justified in circumstances so far removed from those addressed in *Basic*. See *Hevesi* v. *Citigroup, Inc.*, 366 F.3d 70, 78-80 (2d Cir. 2004); *DeMarco* v. *Lehman Bros.*, 222 F.R.D. 243 (S.D.N.Y. 2004).

Congress understood that security prices "rise or fall for reasons unrelated to the alleged fraud" and insisted that plaintiffs may recover only for "losses caused by the fraud

and not by other market conditions." H.R. Conf. Rep. at 42. Plaintiffs may not simply "presume" that market prices were affected for lengthy periods but should have to disentangle any price effects of "tie in" purchases and analyst opinions from effects of other events. That task is "complex and uncertain" (*ibid.*), and not ordinarily possible in a class proceeding. Econometric tools for segregating the price effects of particular events are largely useless over long class periods. See *Elkind* v. *Liggett & Myers*, 635 F.2d 156, 171 (2d Cir. 1980) (it is "difficult if not impossible" to prove over more than a "short period" "the time when and extent to which the integrity of the market was affected" by alleged misconduct not involving issuer statements; "unrelated factors affecting the market price" make it "impossible as a practical matter to isolate" any "rise or decline in market price * * * caused by" that conduct); *Greenberg* v. *Crossroads Sys.*, 364 F.3d 657, 665 (5th Cir. 2004) (plaintiffs must show "stock's price was actually affected" by fraud, segregating effect of other factors, otherwise presumption of reliance and causation "would be based solely on speculation"); *Basic*, 485 U.S. at 253-255 (White & O'Connor, JJ., concurring in part and dissenting in part) (fraud-on-the-market approach is subject to limits of economic theory).[3]

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[3] See also Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 627-628 (1985) (the longer the period examined the poorer "our ability to match particular pieces of news with the effects attributable to them"). Index comparisons cannot account for firm-specific factors. See *Akerman* v. *Oryx Communications*, 810 F.2d 336, 342-343 (2d Cir. 1987) (expert's "statistical analys[e]s" purporting to show that stock had gone down more than an index and had underperformed 82 of 100 new issues "lack[ed] credibility because they fail[ed] to reflect any of the countless variables that might affect the stock price performance of a single company").

The difficulty of disentangling effects of fraud and extraneous market factors over months or years is exacerbated in the tumultuous stock bubble market. See Langevoort, *Taming the Animal Spirits of the Stock Markets*, 97 NW. U.L. REV. 135, 177-178 (2002) ("noise and the presence of other information" render calculations of price effect of events "imprecise," "unusable," and "increasingly doubtful" as the time period under consideration lengthens); Dunbar & Heller, *Fraud on the Market Meets Behavioral Finance*, COLUM. L. SCH. CENTER FOR L. & ECON. STUD. (Dec. 1, 2003), http://www.law.columbia.edu/center_program/law_economics/wkshops/fall2003#81253.[4]

Determining whether plaintiffs have a viable loss causation claim cannot be deferred until trial. "If a defendant cannot win an early dismissal of the case, 'the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial.'" S. Rep. at 7 (1995), quoting SEC Chairman Arthur Levitt. Accord *Blue Chip Stamps*, 421 U.S. at 740-741. The PSLRA's heightened pleading requirement and overt mandate that plaintiff must "plead" and then "prove" loss causation (H.R. Conf. Rep. at 41), along with the coercive

[4] Economists broadly agree that markets during the bubble were not "efficient," which is a necessary predicate for presuming under *Basic* that information is impounded in a security's market price. See *Gariety* v. *Grant Thornton*, 368 F.3d 356, 365-366 (4th Cir. 2004). The factors routinely used by courts to determine market efficiency—which focus on the existence of an active and developed market—are ill-adapted to assess whether the price of stocks trading in a bubble environment efficiently reflects economic value and are therefore apt to result in a finding of efficiency where economists agree there is none, and thus to an unwarrranted extension of *Basic*. See Dunbar & Heller, *supra*; *Cammer* v. *Bloom*, 711 F. Supp. 1264, 1286-1287 (D.N.J. 1989).

consequences of postponing consideration of loss causation, make dismissal an appropriate remedy to address defects in loss causation allegations.

The most powerful coercive effect of a Section 10(b) damages action derives from a willingness by the trial court to certify the suit as a class action. See *Blair* v. *Equifax Check Servs.*, 181 F.3d 832, 834 (7th Cir. 1999) ("Many corporate executives are unwilling to bet their company that they are in the right in big-stakes litigation, and a grant of class status can propel the stakes of a case into the stratosphere," giving plaintiffs and "even some district judges" a "device to wring settlements from defendants"). It is therefore incumbent on a court considering a motion to certify a class action to make an independent determination whether plaintiffs have met their burden of establishing that loss causation can reliably be proved across the entire proposed class using a fraud-on-the-market presumption or some trustworthy expert formula, or whether proof of causation must instead turn on time- or transaction-specific inquiries incompatible with class adjudication. *E.g.*, *Gariety*, 368 F.3d at 365-366; *West* v. *Prudential Sec.*, 282 F.3d 935, 938 (7th Cir. 2002); *Newton* v. *Merrill Lynch*, 259 F.3d 154, 166 (3d Cir. 2001); *Szabo* v. *Bridgeport Machs.*, 249 F.3d 672, 675 (7th Cir. 2001); see 2 HAZEN, THE LAW OF SECURITIES REGULATION § 12.12[3], at 539 (4th ed. 2002) ("the difficulty in discounting extrinsic market factors" in determining whether plaintiffs have been damaged "necessitate[s] complex analysis"; "the proof may vary from plaintiff to plaintiff and may thus require severing a class action").

Whether defendant's defenses to loss causation will require trade-by-trade or other time-specific inquiry is a key part of this inquiry. *E.g.*, *Amchem Prods., Inc.* v.

Windsor, 521 U.S. 591, 625 (1997); *Visa Check Antitrust Litig.*, 280 F.3d 124, 138 (2d Cir. 2001). The court "may not duck hard questions by observing that each side has some support" from experts. *West*, 282 F.3d at 938-940 (decertifying securities fraud class where "reputable financial economist" failed "to test for and exclude other potential sources of price movement"); *DeMarco*, 222 F.R.D. at 247-249 (refusing to certify class where plaintiffs' expert failed to demonstrate that analyst reports "materially impacted the market price [of the security] in a reasonably quantifiable respect" independent of the plethora of other information, opinion, and "confounding news" entering the market"); *Gariety*, 368 F.3d at 365-366. It would be far too easy an end run around the PSLRA to allow a plaintiff at the class certification stage to show that causation is an issue common to the class by offering speculative expert testimony. See *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 345 (1979) (courts must be "especially alert" to "administrative chaos" and "class-action harassment" at the class certification stage).

II. A RIGOROUS LOSS CAUSATION STANDARD THAT GUARDS AGAINST BLACKMAIL SETTLEMENTS AND WINDFALL RECOVERIES WILL NOT UNDERMINE THE DETERRENCE AND COMPENSATION POLICIES OF THE SECURITIES LAWS.

This Court need have no fear that requiring Section 10(b) plaintiffs to satisfy a rigorous, non-speculative loss causation standard, as Congress intended, will undermine the deterrence and compensation policies of the securities laws or hobble their enforcement. The SEC disagrees with plaintiffs that a diluted loss causation standard is necessary to effective operation of the securities laws, and for good reason. "[T]he deterrent effect is weak" when "the merits of claims" are "irrelevant to their initiation or settlement

values," as is the case with many Section 10(b) damages suits. Winter, *supra*, 42 DUKE L.J. at 952. Meritorious securities fraud suits, of course, will satisfy a rigorous causation standard. And a plethora of other judicial and administrative remedies targeted at truly wrongful conduct by expert regulators and prosecutors also ensure that a rigorous causation standard will not have adverse effects.

SEC regulations impose stringent reporting obligations on corporations, subject to SEC enforcement proceedings. Corporations must file quarterly and annual financial statements, which executives now must certify under threat of criminal penalty and disgorgement of their compensation and stock trading profits. 15 U.S.C. §§ 7241, 7243; 18 U.S.C. § 1349. Issuers also must file, within four business days, Form 8-K reports on any of a host of material corporate events, including agreements, acquisitions, disposition of assets, off-balance-sheet financial obligations, and changes in officers or directors. SEC, Release No. 33-8400, 69 Fed. Reg. 15594 (2004).

The powers of the SEC and Department of Justice to enforce corporate disclosure obligations are substantial and do not depend on proving loss causation. The Commission may obtain injunctive relief, cease-and-desist orders, orders barring or suspending individuals from serving as an officer or director of an issuer of securities, and large civil penalties, including disgorgement of any gain. 15 U.S.C. §§ 78u, 78u-3; see *SEC* v. *First Jersey Sec.*, 101 F.3d 1450 (2d Cir. 1996) (requiring disgorgement of $75 million). Under the Sarbanes-Oxley Act, the SEC may earmark penalties and amounts disgorged "for the benefit of the victims" of the violation. 15 U.S.C. § 7246(a).

A person who willfully and knowingly makes a false or misleading statement of material fact may also be criminally liable and is subject to imprisonment for 20

years and multi-million dollar fines. *Id.* § 78ff. The recent indictment of Enron CEO Kenneth Lay, for example, rests in part on statements he made about the company in an online employee forum and in calls with research analysts. See Coffee, *Overcriminalization?*, NAT'L L.J., Aug. 16, 2004, at 13. Insiders who trade with knowledge of material information that has not been disclosed to the public face civil penalties of three times the profit gained or loss avoided. 15 U.S.C. § 78u-1. The Securities Act authorizes many similar remedies for misstatements made in connection with the registration of securities, for which liability may be established without proof of scienter. *Id.* §§ 77t, 77y. Underwriters and broker-dealers are subject to equivalent deterrent and remedial sanctions, as well as a host of specialized standards applicable to their operations.

The SEC is not reluctant to use these powers. The goal of SEC enforcers has been described by former Chairman Richard Breeden as leaving securities law violators "naked, homeless, and without wheels." Eisenberg, *Enforcement Issues and Litigation*, 21 SEC. REG. L.J. 421, 421 (1994). In the aftermath of the bubble and recent corporate scandals the Commission's 900-strong enforcement staff has shown extraordinary vigor. During fiscal year 2003 alone the SEC brought 271 injunctive actions and 365 administrative proceedings against issuers and financial services providers—far more than the 216 private securities class actions filed in federal court in 2003 (see http://securities.stanford.edu)—and obtained orders requiring the disgorgement of $900 million and the payment of $1.1 billion in penalties. SEC 1993 Annual Report 15, http://www.sec.gov/pdf/annrep03/ar03enforce.pdf. Recently, the SEC and other regulators obtained a $1.4 billion settlement from ten securities firms accused of issuing research opinions tainted by conflicts of interest, and well over a billion dollars in settlements with mutual

fund companies accused of market-timing violations, specialist firms accused of "front running," and underwriters accused of IPO allocation violations.[5] The Department of Justice's Corporate Fraud Task Force has charged hundreds of defendants since it was formed in July 2001, including senior officers and managers of securities issuers and employees of financial services companies, obtaining many guilty pleas and convictions. http://www.usdoj.gov/dag/cftf.

State prosecutors and blue-sky officials bring their own overlapping civil and criminal enforcement actions. Among state securities law enforcers, for example, the New York Attorney General alone has reported substantially more than $1 billion in settlements with financial services companies already in 2004. http://www.oag.state.ny.us/press/agpress04.html.

Financial services industry Self Regulating Organizations ("SROs") actively enforce their regulations, which implement and supplement the securities laws. In 2003 the National Association of Securities Dealers ("NASD") barred 494 individuals from the securities business, suspended 333 others, and expelled 30 firms. http://www.nasdr.com/2380.asp. The New York Stock Exchange brought 231 cases of rules violations against members that

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[5] *E.g.*, http://www.sec.gov/news/press/2002-179.htm ($1.4 billion global settlement in analyst conflict of interest cases); *id.* at 2004-14.htm ($225 million settlement in case alleging market timing trading in mutual funds); *id.* at 2003-176.htm ($250 million market timing settlement); *id.* at 2004-42.htm ($240 million settlement in case against five specialist firms for executing orders for dealer accounts ahead of executable public customer orders); *id.* at 2002-14.txt ($100 million settlement for alleged practices relating to allocations of stock in IPOs).

year. http://www.nyse.com/regulation/p1020656068597.html?displayPage=%Fregulation%2F1022221394131.html.

Furthermore, agreements between broker-dealers and their customers invariably include arbitration provisions. NASD arbitration, which this Court has strongly endorsed as a means to resolve securities fraud claims, is thus readily available to investors. NASD MANUAL § 10101; see *Shearson/American Express* v. *McMahon*, 482 U.S. 220, 232 (1987) (describing the "suitability of arbitration as a means of enforcing Exchange Act rights" and "competence of arbitral tribunals to resolve § 10(b) claims"). Arbitration focuses directly on the central issues in dispute, such as whether a client has been directed to unsuitable investments or a broker made a material misstatement to the customer. Arbitration—in which legal representation and discovery are available and experienced decisionmakers consider the facts and circumstances of each case—is less costly and quicker than litigation and increases the share of recovery that an investor retains. See *Howsam* v. *Dean Witter*, 537 U.S. 79, 85 (2002) (NASD arbitrators' "comparative expertise" helps "to secure a fair and expeditious resolution of the underlying controversy"). Smaller claims are channeled into a simpler procedure for even faster and more economic resolution. NASD MANUAL §§ 10302, 10316, 10321-10322.

Since the stock market bubble burst, thousands of investors have discovered that arbitration provides a fair and efficient forum for resolution of claims against broker-dealers. Nearly 9000 arbitration cases were filed with NASD in 2003. Customers received awards in more than half of the 7300 NASD arbitration cases closed that year. See http://www.nasdadr.com/statistics.asp.

Securities market participants are thus hemmed in by an array of federal and state government powers, both civil

and criminal, SRO sanctions, and arbitral remedies, which effectively curb unlawful practices and compensate non-speculative injuries. As Judge Friendly observed, "[t]he important thing is to stop the evil conduct" and "an injunction," "fines," or other sanctions imposed at the behest of expert government and SRO regulators achieve that purpose without the risk attendant on civil damages actions of "ruin[ing] innocent stockholders," "produc[ing] blackmail settlements," or deterring desirable conduct. FRIENDLY, *supra*, at 120. Given the availability of these fact-specific remedies, which deter and punish misconduct and compensate those who truly are its victims, there is no reason why this Court should recognize, in a judicially implied cause of action, a class-wide liability that rests on speculative inferences of causation.

Indeed, even against the background of a far more rudimentary enforcement system than exists today, this Court refused in *Piper* v. *Chris-Craft Indus.*, 430 U.S. 1 (1977), to imply a cause of action for damages for violation of Section 14(e) of the Exchange Act—prohibiting fraud in connection with a tender offer—because the threat of damages was not necessary to deter fraudulent conduct. "[I]njunctive relief" is more effective than "a damages award" that also "may well be inconsistent with the interests of many members of the protected class." *Id.* at 42. Reversing a court of appeals' ruling that implied a damages cause of action and invoked a "presumption of reliance and causation" in the name of deterrence and "effective" remedies (*id.* at 17-18), this Court observed that "uncertainties" about whether particular conduct amounts to a legal violation and "caused injury" "call into question whether 'deterrence' of § 14(e) violations is a meaningful goal" except for "the most flagrant sort of violations which no reasonable person could consider lawful." *Id.* at 40 n.26. And for those

"obvious and serious" violations, "injunctive relief" is "apt to be the most efficacious form of remedy." *Ibid.*[6]

Congress has limited recovery to "actual damages on account of the act complained of" (15 U.S.C. § 78bb(a)) and required plaintiffs to plead and prove that the misrepresentation or omission "caused the loss for which the plaintiff seeks to recover." *Id.* § 78u-4(b)(4). Particularly in light of the alternative remedies and sanctions, "any extension of [the securities] laws, to approach something closer to [the] investor insurance scheme" that plaintiffs seek "should come from Congress, and not from the courts." *Basic*, 485 U.S. at 256-257 (White & O'Connor, JJ., concurring in part and dissenting in part).

CONCLUSION

The judgment of the Ninth Circuit should be reversed.

Respectfully submitted.

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[6] Quite apart from the panoply of available legal remedies, self-interest provides a powerful incentive to timely and truthful disclosure. "[T]he market provides strong incentives for anyone who desires continued access to the market to keep the signals honest." KRIPKE, *supra*, at 126; see *Piper*, 430 U.S. at 40 n.26.

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In The Supreme Court of the United States

DURA PHARMACEUTICALS, INC. *et al.*,

Petitioners,

v.

MICHAEL BROUDO *et al.*,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR *AMICI CURIAE* NATIONAL ASSOCIATION OF SHAREHOLDER AND CONSUMER ATTORNEYS, AARP, AND THE CONSUMER FEDERATION OF AMERICA IN SUPPORT OF RESPONDENTS

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I. INTEREST OF *AMICI CURIAE*[1]

AARP is a nonprofit, non-partisan organization with more than 35 million members, dedicated to addressing the needs and interests of Americans aged 50 and older. As the largest membership organization representing the interests of older Americans, AARP is very concerned about fraudulent practices in the securities industry and our capital markets. Older people are frequent targets of fraud because they often have significant assets and are looking for investment opportunities to supplement the Social Security and pension benefits they will receive during retirement. As a result, AARP has made the need to combat securities fraud a high priority, and advocates the availability and enforcement of adequate federal and state statutory remedies to provide victims with financial redress.

The Naticnal Association of Shareholder and Consumer Attorneys ("NASCAT") is a nonprofit membership organization founded in 1989. The member law firms represent investors (both individuals and institutions) and consumers in securities fraud and shareholder derivative cases throughout the United States. NASCAT and its members are devoted to representing victims of corporate abuse, fraudulent schemes, and so-called "white-collar" criminal activity in cases that have the potential for advancing the state of the law, educating the public, modifying corporate behavior, and improving access to

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[1] In accordance with Rule 37.6, counsel for AARP, NASCAT, and CFA represent that they authored this brief and that no person other than these *amici curiae* or their counsel made a monetary contribution to its preparation or submission. Petitioners and Respondents have consented to the filing of this brief.

justice and compensation for the wrongs inflicted upon victims. NASCAT advocates the principled interpretation and application of the federal securities laws – including the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act"), and the Private Securities Litigation Reform Act of 1995 (the "PSLRA") – to protect investors from manipulative, deceptive and fraudulent practices and to ensure that the nation's securities markets operate fairly and efficiently.

The Consumer Federation of America ("CFA") is a nonprofit association of 300 consumer groups that represent more than 50 million Americans. It was established in 1968 to advance the consumer's interest through research, education, and advocacy. As increasing numbers of Americans have come to rely on the nation's financial markets to fund their retirements and save for other long-term goals, CFA has made enhancing investor protections a top legislative and regulatory priority. CFA's policies in this area are based on a fundamental belief that investors are entitled to a marketplace that provides them with a choice of appropriate investments and service providers, the information necessary to make informed choices, protection against fraud and abuse, and effective recourse when they are the victims of wrongdoing. To achieve that goal, CFA has for nearly two decades been actively involved in efforts to promote investor protection legislation and regulations, and to oppose efforts to weaken those protections, at the state and federal levels. Consistent with its belief that access to redress for wrongdoing is essential to maintaining investor faith in the integrity of our securities markets, CFA's efforts have included opposition to measures that would limit the ability of defrauded investors to recover their losses in court.

AARP and NASCAT have previously filed *amicus curiae* briefs in this Court in cases involving the construction and application of the Federal securities laws.[2]

II. INTRODUCTION

This case concerns the "loss causation" element of investors' claims seeking to recover damages under Section 10(b) of the 1934 Act and Rule 10b-5 promulgated by the Securities and Exchange Commission ("SEC"). For the reasons stated above, AARP, NASCAT and CFA are qualified to advise this Court, as *amici curiae,* of the meaning and import of Section 21D(b)(4) of the PSLRA, which codified the "loss causation" elements of Section 10(b)/Rule 10b-5 claims recognized by the circuit courts two generations ago. We note that the courts below did not analyze the language or meaning of that statutory provision in this case; however, *amici* believe that when this Court examines the relevant statutory language and the record, it will agree that Respondents properly alleged the "loss causation" element of their securities fraud claims against Petitioners. Further, AARP, NASCAT and CFA believe that the Ninth Circuit's ruling concerning the "loss causation" requirement is consistent with the important public policies underlying the federal securities laws, and that affirming the decision of the court below will further the

[2] *See SEC v. Edwards*, 540 U.S. 389 (2004) (AARP); *SEC v. Zandford*, 535 U.S. 813 (2002) (AARP-NASCAT); *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994) (NASCAT); *Musick, Peeler & Garrett v. Employers Ins.*, 508 U.S. 286 (1993) (NASCAT).

goal of protecting victims of investment fraud and help ensure they can obtain adequate recovery for their losses.

AARP, NASCAT and CFA submit that any reasoned analysis of the PSLRA's statutory provisions, and their application to the facts and circumstances of this case, must take into account the unprecedented wave of corporate scandals and schemes to violate the federal securities laws that have infected our securities markets over the past ten years. Well-publicized financial scandals at Enron, WorldCom, Qwest, Global Crossing, Adelphia Communications, ImClone Systems, and Tyco International have cost shareholders ***more than $460 billion***.[3] These financial scandals caused investors to question the fundamentals of investing and corporate responsibility.[4] Investors' confidence in the U.S. stock market was so low that in June 2002, investors withdrew more than $18 billion from stock funds, the third largest such withdrawal in history. Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801, 806 (2003). Professor Morrissey asserts that these corporate and accounting scandals

[3] *See* John Paul Lucci, *Enron – The Bankruptcy Heard Around the World and the International Ricochet of Sarbanes-Oxley*, 67 ALB. L. REV. 211, 212 (2003). When filed, Enron's bankruptcy was the largest in U.S. history, and shareholders lost in excess of $60 billion in market value of Enron's stock. Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud and September 11, 2001*, 76 TUL. L. REV. 1579 (2002); *see also* John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2004); Marianne M. Jennings, *A Primer on Enron: Lessons from a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163 (2003); Steven Schwarcz, *Some Thoughts on the Enron Bankruptcy*, 70 U. CIN. L. REV. 1309 (2002).

[4] Ethan G. Zelizer, *The Sarbanes-Oxley Act: Accounting for Corporate Corruption?*, 15 LOY. CONSUMER L. REV. 27, 27 (2002).

demonstrate that "corporate America and its industry insiders (including accountants, investment bankers, brokers and lawyers) seem to influence – if not make – the rules, but subsequently take liberties in complying with or ignoring these rules as they see fit." *Id.* He also poses the following questions that this Court should consider in deciding this case:

> Is there a rule of law in corporate America? Alternatively, have the professional and corporate managerial classes in America been participating in a scheme to present the investing world with a system that seems to be ruled by law but in fact is not? At the same time, the professional and managerial classes have enjoyed enormous profits while most investors have sat by with little recourse or compensation to redress their losses resulting from fraud in the securities markets. . . .
>
> Any nation purporting to be governed by a rule of law must actually provide for mechanisms of enforcement against fraud and deception in its securities markets.

Id. at 806-07, 809 (footnotes omitted). As the Supreme Court of California has recognized, American business "depends on a national investment market" to support its industry. Effective remedies for fraud and market manipulation help ensure that the flow of capital necessary to the growth of American business will continue. *Diamond Multimedia Systems, Inc. v. Superior Court*, 968 P.2d 539, 557 (Cal. 1999).

When it enacted the PSLRA, Congress codified private securities actions as "an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action." H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S. CODE CONG. &

ADMIN. NEWS 730, 731. Lawmakers concluded in 1995 that class actions (like this case) are socially beneficial, both for compensating victims of securities fraud and for deterring future wrongdoing by corporate actors, thereby promoting confidence in the nation's securities markets. *Id.* at 31-32.[5] Private securities litigation "promotes public and global confidence in our capital markets and helps to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers, and others properly perform their jobs." *Id.* at 31; *see also* Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 B.Y.U. L. REV. 1239, 1247-50 (2003). Over the past forty years, this Court has repeatedly recognized an implied private right of action to enforce the securities laws as a supplement to government regulatory efforts for the benefit of defrauded investors and the capital markets generally. *See Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 315 (1985); *Deposit Guaranty Nat'l Bank v. Roper*, 445 U.S. 326, 339 (1980); *J. I. Case Co. v. Borak*, 377

[5] More than a decade ago, then-SEC Chairman Richard Breeden told lawmakers that budgetary limitations meant that private class actions must "perform a critical role in preserving the integrity of our securities markets." *Securities Investor Protection Act of 1991: Hearing on S. 1533 Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous. & Urban Affairs*, 102nd Cong. 15-16 (1992) (testimony of then-SEC Chairman Richard C. Breeden). A few years later, Breeden's successor, Arthur Levitt, declared that private lawsuits, rather than government actions, had become "the primary vehicle for compensating defrauded investors." *Common Sense Legal Reform Act: Hearing Before the Subcomm. on Telecomm. & Fin. of the House Comm. on Commerce*, 104th Cong. 1 (1995) (prepared statement of then-SEC Chairman Arthur Levitt) ("Private actions . . . provide a 'necessary supplement' to the [SEC's] own enforcement activities by serving to deter securities law violations. Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws.") (footnote omitted).

U.S. 426, 432 (1964). The PSLRA has now made that implied right an explicit statutory right of action.

Petitioners and their *amici* ignore these important public policies, just as they ignore the express language of the PSLRA's "loss causation" provision at issue in this case. The briefs they filed in this Court fail to mention the ongoing corporate and accounting scandals that have robbed investors of their life savings and sapped their confidence in the securities markets. Needless to say, they also fail to acknowledge some of their own roles in causing billions of dollars in shareholder losses or their potential liability to investors when and if pending securities fraud actions are resolved against them. *See* note 26, *supra*. Their deliberately incorrect reading of the PSLRA would make it much more difficult – if not impossible – for the defrauded investors who lost hundreds of billions of dollars in recent corporate and accounting scandals to recover their losses. This unfortunate result cannot, and should not, be countenanced by this Court.

III. ARGUMENT

A. SECTION 21D OF THE PSLRA DID NOT CHANGE THE TRADITIONAL PLEADING RULES CONCERNING THE "LOSS CAUSATION" ELEMENT OF SECURITIES FRAUD CLAIMS

To state a claim for securities fraud under Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, Respondents must allege that Petitioners (1) made a false statement or omission; (2) of a material fact; (3) with scienter; (4) in connection with the purchase or sale of securities; (5) upon which Respondents justifiably (or reasonably) relied; and (6) that Respondents'

reliance was the proximate cause of their injury. *See, e.g., Miller v. Asensio & Co.*, 364 F.3d 223, 227 (4th Cir. 2004); *In re K-Tel Int'l Sec. Litig.*, 300 F.3d 881, 888 (8th Cir. 2002); *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 174 (3d Cir. 2000).

The Question Presented addresses only the ***causation*** requirement of a Section 10(b)/Rule 10b-5 claim, which has two components: Respondents must allege and prove at trial (a) that Petitioners' violations of the securities laws caused Respondents to engage in their stock transactions ("transaction causation") and (b) that the misrepresentations, omissions, or other violations caused Respondents' harm ("loss causation"). *See Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 179 (2d Cir. 2001). "Transaction causation" is the causal connection between a securities fraud defendant's fraud and plaintiff's entering in the transaction in question. *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974); *see also Ambassador Hotel Co. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1027 (9th Cir. 1999) (establishing transaction causation requires the plaintiff to prove that "but for the fraud, the plaintiff would not have engaged in the transaction at issue"). "[T]ransaction causation is generally understood as reliance." *Castellano*, 257 F.3d at 186. Under *Basic Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988), a rebuttable presumption of "transaction causation" is established under the "fraud on the market" theory, even if Respondents were unaware of the fraudulent conduct at the time of their purchases of Dura's common stock.[6] But the

[6] Under the "fraud on the market" doctrine, the trial court must presume that (a) the market price of Dura's common stock actually

(Continued on following page)

"transaction causation" component of securities fraud causation is ***not*** an issue in this case.[7]

Contrary to Petitioners' assertion, nothing in the PSLRA heightened the pleading requirements for the "loss causation" element of Section 10(b)/Rule 10b-5 claims. Rather, as codified in Section 21D(b)(4) of the PSLRA, Respondents have the "burden of **proving** that the act or omission of the [Petitioners] . . . caused the loss for which the [Respondents] seek[] to recover damages." 15 U.S.C. § 78u-4(b)(4) (emphasis added). In a misguided effort to convince this Court to impose a heightened pleading burden, Petitioners and their *amici* misstate the express

incorporated Petitioners' alleged misrepresentations; (b) Respondents actually relied on the market price of those securities as an indicator of their value; and (c) Respondents acted reasonably in relying on the market price of Dura's stock. *Id.* Paragraphs 37, 48, 51, 55, 85, 111, 128, 138 and 174 of Respondents' Second Amended Complaint allege the necessary facts: Dura's common stock traded in an efficient market on the NASDAQ National Market System; the company filed periodic public reports with the SEC; and Respondents and Class members purchased stock during the Class Period. These allegations are sufficient to establish reliance. *See, e.g., In re Ravisent Techs., Inc. Sec. Litig.*, 2004 U.S. Dist. LEXIS 13255, at *45-46, 2004 WL 1563024 (E.D. Pa. July 12, 2004); *Fogarazzo v. Lehman Bros., Inc.*, 2004 U.S. Dist. LEXIS 9193, at *29, 2004 WL 1151542 (S.D.N.Y. May 21, 2004); *In re Initial Pub. Offering Sec. Litig.*, 297 F. Supp. 2d 668, 670 (S.D.N.Y. 2003).

[7] Citing *Basic*, 485 U.S. at 247, some courts recognize a presumption of "loss causation," asserting that in "fraud-on-the-market" cases, "[c]ausation lies in the fact that the plaintiff relied on the market price of the security as an indicator of the future value of the stock. To the extent that the defendant's misrepresentations artificially altered the price of the stock and defrauded the market, causation is presumed." *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619-20 (8th Cir. 1991); *accord DeMarco v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 110, 124-25 (S.D.N.Y. 2004) (collecting cases).

statutory language of the PSLRA.[8] "However, the PSLRA did not change traditional pleading rules with respect to causation." *Johnson v. Aljian,* 2004 U.S. Dist. LEXIS 14986, at *53 (C.D. Cal. July 30, 2004) (citing *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 830 n.3 (8th Cir. 2003) (noting that the PSLRA's heightened standard for pleading misrepresentations "is not involved in this appeal"; "The complaint's allegations of misconduct are involved here only as they relate to the questions of materiality and loss causation. The new statute does not change traditional pleading rules with respect to those issues."), and *Coates v. Heartland Wireless Comm., Inc.*, 26 F. Supp. 2d 910, 923 (N.D. Tex. 1998) ("the PSLRA does not alter the standards for pleading loss causation")). As the Third Circuit has stated, "this provision" – Section 21D(b)(4) – "does not deal with pleading." *EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 883 (3d Cir. 2000).

"Because the PSLRA does not affect causation pleadings, Plaintiffs' causation pleadings must only meet the traditional 'fair notice' standards" of FED. R. CIV. P. 8(a). *In re Electronic Data Sys. Corp. Sec. & "ERISA" Litig.*, 298 F. Supp. 2d 544, 560 (E.D. Tex. 2004). The Solicitor General asserts that "because loss causation is an element of a fraud cause of action, the allegations must be 'stated with particularity.'" Sol. Gen. Br. at 15 (quoting FED. R. CIV. P. 9(b)). But Rule 9(b) does not say that, and no case applying the PSLRA has so held.

[8] *See, e.g.*, Brief for Petitioners ("Pet. Br.") at 11 (claiming that Section 21D(b)(4) of PSLRA "requires that a plaintiff plead and prove" loss causation); *id.* at 4 (same; "pleading and proving"); *id.* at 15 (asserting that "Congress codified a plaintiff's burden of pleading and proving 'loss causation' in [Section] 10(b) cases"); *id.* at 20 (same). The Brief for the United States as Amicus Curiae ("Sol. Gen. Br.") offers the same distortion of the express statutory language. *See* Sol. Gen. Br. at 6, 8.

In contrast, other subdivisions of Section 21D of the PSLRA, when read in conjunction with FED. R. CIV. P. 9(b), impose heightened pleading requirements that must be satisfied for a complaint sounding in securities fraud to survive a motion to dismiss. For example, Section 21D(b)(1) requires plaintiffs to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).[9] Section 21D(b)(2) also modifies the burden of pleading intent, or scienter, by requiring plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).[10] Thus, under Section 21D of the PSLRA, both falsity and scienter must be alleged with particularity. *See In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 743 (8th Cir. 2002). Reference to these statutory provisions makes clear that Congress knew how and when to impose a heightened pleading burden when it enacted the PSLRA; however, Congress did not do so in Section 21D(b)(4), the "loss causation" provision at issue in this case.

This conclusion is supported by reference to Section 21D(b)(3) of the PSLRA, which states in relevant part: "Dismissal for failure to meet pleading requirements. In

[9] *See, e.g., In re Rockefeller Ctr. Props. Sec. Litig.*, 311 F.3d 198, 218 (3d Cir. 2002) (this "particularity [requirement] . . . extends that of Rule 9(b) and requires plaintiffs to set forth the details of allegedly fraudulent statements or omissions, including who was involved, where the events took place, when the events took place, and why any statements were misleading"). *Accord In re Digital Islands Sec. Litig.*, 357 F.3d 322, 329 (3d Cir. 2004); *In re NUI Sec. Litig.*, 314 F. Supp. 2d 388, 397-98 (D.N.J. 2004).

[10] *See, e.g., Digital Isl.*, 357 F.3d at 329; *NUI Sec.*, 314 F. Supp. 2d at 397-98.

any private action arising under this title, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met." 15 U.S.C. § 78u-4(b)(3)(A).[11] Petitioners and their *amici* ignore Section 21D(b)(3) and its significance. *See, e.g.*, Sol. Gen. Br. at 15. If, as they would have this Court believe, Section 21D(b)(4) imposes a heightened pleading burden for the "loss causation" element, why does Section 21D(b)(3)(A) not direct district courts to dismiss cases that fail to meet that supposed "pleading" burden?

Certain lower federal courts, grasping at threads of the PSLRA's legislative history, assert that Section 21D(b)(4) imposes a heightened pleading requirement for the "loss causation" element of Section 10(b)/Rule 10b-5 securities fraud claims. *See, e.g., D.E. & J.L.P. v. Conaway*, 284 F. Supp. 2d 719, 746 (E.D. Mich. 2003). Because the text of Section 21D(b)(4) is plain and unambiguous, however, there is no need to resort to the PSLRA's legislative history.[12] *See, e.g., Desert Palace, Inc. v. Costa*, 539

[11] Under Section 21D(b)(3), "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss" a securities fraud complaint, "unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." 15 U.S.C. § 78u-4(b)(3). During the district court proceedings in this case, the PSLRA's "discovery stay" remained in effect and no discovery was conducted.

[12] Indeed, Petitioners laud the "plain language of the [PSLRA]," including Section 21D(b)(4). Pet. Br. at 11. Petitioners cite the "broad" or "overall statutory scheme" of the PSLRA, observing that it amended Section 12(b) of the 1933 Act to provide defendants with an "affirmative defense" of "loss causation." Pet Br. at 11, 15, 18-19. Section 12(b) requires defendants to "***prove***[ ]" that affirmative defense at trial. 15 U.S.C. § 77*l*(b) (emphasis added). As Petitioners concede, it is a "basic canon of statutory construction that identical terms within an Act bear the same meaning." Pet. Br. at 20 n.6 (quoting *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 479 (1992)). Therefore, one must

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U.S. 90, 98 (2003) ("And where, as here, the words of the statute are unambiguous, the judicial inquiry is complete.") (citations and internal quotation marks omitted).

Nevertheless, reference to the Senate Report that Congress submitted with the PSLRA demonstrates that Section 21D(b)(4) merely codified securities fraud plaintiffs' burden to **prove** "loss causation" at trial:

> The Committee also requires the plaintiff to show that the misstatement or loss alleged in the complaint caused the loss incurred by the plaintiff. For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission. The defendant would then have the opportunity to prove any mitigating circumstances, or that factors unrelated to the fraud contributed to the loss.

S. Rep. No. 104-98, at 15 (1995), *reprinted in* 1995 U.S. CODE CONG. & ADMIN. NEWS 679, 694.[13] To whatever extent this

conclude that the word "***proves***" in Section 12(b) of the 1933 Act means the same thing as "***proving***" in Section 21D(b)(4) of the 1934 Act. Petitioners do not explain how an "affirmative defense" of "loss causation" can be "prove[n]" on a motion to dismiss where (as here) they have yet to answer Respondents' Complaint.

[13] S. 240, entitled "The Private Securities Litigation Reform Act of 1995," was introduced in January 1995. S. 240, 104th Cong. (1995). *See* John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 350 (1996) (discussing introduction of S. 240). The first version of S. 240, dated January 22, 1995, contained the following "loss causation" provision:

> and in which the plaintiff claims to have bought or sold the security based on a reasonable belief that the market value of the security reflected all publicly available information, the plaintiff shall have the burden of proving that the misstatement or omission caused any loss incurred by the plaintiff.

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Court can even consider the PSLRA's relevant legislative history, nothing in the Senate Report even hints at a heightened pleading burden for the "loss causation" element.

With regard to securities fraud actions that are subject to the PSLRA, the Seventh Circuit has pronounced that loss causation is a "practical requirement" that "ought not place unrealistic burdens on the plaintiff at the initial pleading stage." *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997). "It does not require . . . that the plaintiff plead that all of its loss can be attributed to the false statement of the defendant." *Id.*; *accord In re Enron Corp. Sec. Litig.*, 310 F. Supp. 2d 819, 831-32 (S.D. Tex. 2004); *In re Rhythms Sec. Litig.*, 300 F. Supp. 2d 1081, 1092 (D. Colo. 2004) ("It is not Plaintiffs' burden to prove loss causation in the pleadings.") (citation omitted).

In order to survive a motion to dismiss for failure to plead loss causation, Respondents must "adequately allege a causal connection between" Petitioners' misleading statements or omissions and the decline in value of Dura's common stock. *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003). Although Petitioners might be able to demonstrate that some intervening event caused investors' losses, "such is a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss." *Id.*[14]

S. 240, § 104. Conferees of the Senate and House met in November 1995 and reconciled the differences between S. 240 and the House bill, H.R. 1058, which also contained a "loss causation" provision. Although the conferees made several significant changes, the bill's final form was predominantly based on the Senate version.

[14] The same is true of the "truth-on-the-market" defense, where securities fraud defendants seek to counter the "fraud-on-the-market" reliance presumption (*see* note 6, *supra*) by showing that the investing

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As Petitioners observe, "loss causation" allows courts to "take account of intervening factors, such as a war or a recession, that may have caused the price decline" of a particular stock. Pet. Br. at 21. Given the procedural posture of this case, Petitioners cannot identify any such "intervening factors," and they did not do so in the courts below. According to the Second Circuit, "if the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation will not have been established. But such is a matter of proof at trial and not to be decided" on a motion to dismiss. *Emergent Capital*, 343 F.3d at 197; *accord In re Initial Pub. Offering Sec. Litig.*, 2004 U.S. Dist. LEXIS 20497, at *166 & n.378, 2004 WL 2297401 (S.D.N.Y. Oct. 13, 2004). This Court recognized in *Basic*, 485 U.S. at 249 n.29, that "[p]roof of that sort is a matter for trial."[15]

In pre-PSLRA cases, the federal courts uniformly recognized that securities fraud plaintiffs were required to prove "loss causation" at trial, and that "causation" issues presented factual questions that must be resolved by juries. *See, e.g., Blackie v. Barrack*, 524 F.2d 891, 906 n.22 (9th Cir. 1975). The Seventh Circuit recognizes that

public received accurate, "corrective information" from an alternate source "with a degree of intensity and credibility sufficient to counterbalance effectively any misleading information created by the alleged misstatements." *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 (2d Cir. 2000) (citation omitted). "[T]he truth-on-the-market defense is intensely fact-specific and is rarely an appropriate basis for dismissing a [Section] 10(b) complaint for failure to plead materiality." *Id.*

[15] *Accord In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 2004 U.S. Dist. LEXIS 13147, at *58-59, 2004 WL 1554840 (S.D.N.Y. 2004); *DeMarco*, 318 F. Supp. 2d at 124 & n.6 (while "defendants may be able to show after discovery that an unforeseeable intervening event caused the stock price to decline," court recognized that "[t]hese are all matters for the factfinder on a fully-developed record"); *In re Initial Public Offering Sec. Litig.*, 297 F. Supp. 2d 668, 675 & n.33 (S.D.N.Y. 2003) (same).

nothing precludes a securities fraud defendant "from submitting, at the summary judgment stage, that [plaintiff] cannot prove the loss causation that it has alleged" in the complaint. *Caremark,* 113 F.3d at 649. "At summary judgment, this burden usually is met by establishing that the decline in the value of the security is attributable in total to some other factor." *Id.* at 649-50 (citation omitted). "To defeat Caremark's claim at summary judgment, . . . Coram would have to establish that, as a matter of undisputed fact, the depreciation in the value of the [securities] could not have resulted from the alleged false statement or omission of the defendant." *Id.* at 650.[16]

This approach was typified by *Huddleston v. Herman & MacLean,* 640 F.2d 534 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds,* 459 U.S. 375 (1983), a securities fraud class action brought by investors who alleged that misstatements had been made by defendants in the prospectus for a securities offering to raise money to construct an automobile racetrack. Investors proved at

[16] Thus, in *In re AOL Time-Warner Sec. & "ERISA" Litig.*, 2004 U.S. Dist. LEXIS 7917, 2004 WL 992991, Fed. Sec. L. Rep. (CCH) ¶ 92,812 (S.D.N.Y. May 5, 2004), a securities fraud class action was filed following the restatement of $477 million in advertising revenue purportedly earned by AOL Time Warner ("AOLTW"). In its motion to dismiss, AOLTW contended that Plaintiff's "economic harm was not a result of the alleged misrepresentations, but rather the product of intervening external forces, such as the marketwide decline in Internet stocks and the fallout from the September 11 [, 2001] terrorist attacks." 2004 U.S. Dist. LEXIS 7917, at *96-97. Judge Kram stated that "defendants will have every opportunity at trial to prove that the decline in AOLTW stock was caused by September 11, 2001, its aftermath and generalized market conditions; AOLTW will not, however, have that opportunity now [on a motion to dismiss]." *Id.* at *97 n.39; *see also Movitz v. First Nat'l Bank*, 148 F.3d 760, 762 (7th Cir. 1998) (reversing jury verdict for plaintiff real estate investor because defendant bank proved at trial that loss was caused by "disastrous downturn that the Houston real estate market experienced in the early 1980s").

trial that the racetrack's promoters and accountants had fraudulently induced them to purchase stock by overstating the company's working capital and understating the costs of completing the project. 640 F.2d at 539 & n.2. Subsequently, the business failed and the racetrack filed for bankruptcy. After a three-week jury trial, the trial court submitted the case to the jury on special issues concerning whether the speedway prospectus was materially misleading and, if so, whether this was done with scienter of various defendants; however, the judge refused to submit special issues relating to reliance and causation. *Id.* Based upon the jury verdict, the district court awarded the defrauded securities purchasers the difference between the purchase price of the securities and the proceeds received by them on any sale of the securities. The trial court awarded the full purchase price to those investors who still held their securities because those securities essentially were worthless. *Id.* at 554.

On appeal, the Fifth Circuit addressed the problem as an issue of both loss causation and damages calculation. Addressing loss causation, the court ruled that the plaintiff could only prevail if "the untruth was in some reasonably direct, or proximate, way responsible for his loss." *Id.* at 549. The Fifth Circuit stated that the "causation" element is satisfied in a Section 10(b)/Rule 10b-5 case "if the [defendants'] misrepresentation touches upon the reasons for the investment's decline in value." *Id.* "If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under [Section 10(b)/Rule 10b-5] is not permitted." *Id.* (footnote omitted). Because at trial the defendants attributed the racetrack's failure to the materialization of risks described in the prospectus, such as bad weather conditions and lack of

spectator attendance at the racetrack, the trial court erred in failing to instruct the jury on the issue of proximate cause. *Id.* at 549-50. "The trial court's failure to submit the reliance and causation issues to the jury requires us to grant a new trial." *Id.* at 550.[17]

The Fifth Circuit's wisdom in *Huddleston* has stood unchallenged for more than two decades and was echoed by the Third Circuit in *EP Medsystems*, 235 F.3d at 884, which observed that the "causation issue becomes most critical at the proof stage. Whether the plaintiff has proven causation is usually reserved for the trier of fact."[18] Nothing in Section 21D(b)(4) of the PSLRA (or its legislative history, for that matter) changed the traditional pleading rules governing the "loss causation" element of Section 10(b)/Rule 10b-5 claims, or the lower courts'

[17] *See generally* Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357, 363-64 (1991) (discussing *Huddleston*); Andrew L. Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 TEX. L. REV. 469, 478-79 (1988) (same).

[18] In *Robbins v. Koger Props.*, 116 F.3d 1441 (11th Cir. 1997), investors sought to prove at trial that a decline in the company's stock price provided the measure of their loss, but they could not prove any connection between that decline and the accounting fraud alleged. Nevertheless, the jury returned a verdict in the investors' favor. Uncontradicted evidence introduced by defendants at trial showed that the stock dividend was cut because the company was concerned that future financing would be unavailable, not because it "discovered [and then disclosed] that past accounting errors had overstated its cash flow." *Id.* at 1448. Plaintiffs were unable to show that the drop in stock price was related to defendants' alleged misrepresentations, thus, the Eleventh Circuit held that the trial court had properly granted defendants' Rule 51(a) motion to set aside the jury verdict because plaintiffs had failed to satisfy the "loss causation" requirement. *Id.* at 1448-49. In this case, however, because the district court's "loss causation" ruling was made on Petitioners' motion to dismiss Respondents' Complaint, "*Robbins* is inapplicable here." *Danis v. USN Communs., Inc.*, 73 F. Supp. 2d 923, 943 n.13 (N.D. Ill. 1999).

repeated recognition that "causation" issues in securities fraud cases present factual questions for triers of fact. In the following section, we demonstrate that whatever "pleading standard" is employed, Respondents properly pled the "loss causation" element in this case.

B. THE COURT BELOW CORRECTLY HELD THAT RESPONDENTS PROPERLY PLED THE "LOSS CAUSATION" ELEMENT OF THEIR SECTION 10(B)/RULE 10B-5 CLAIMS

In its opinion in this case, the Ninth Circuit correctly posited the test for "loss causation" in a Section 10(b)/Rule 10b-5 case: "In this circuit, loss causation is satisfied where 'the plaintiff shows that the misrepresentation touches upon the reasons for the investment's decline in value.'" *Broudo v. Dura Pharms., Inc.*, 339 F.3d 933 at 937-38 (citations and internal quotations marks omitted).[19] After citing and quoting from Ninth, Second and Eighth Circuit cases offering the same formulation of the applicable "loss causation" test, the court below explained:

> [F]or a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the

[19] This is the same formulation stated by the Fifth Circuit in *Huddleston*, 640 F.2d at 549, as quoted above. Professor Kaufman states that the phrase "touches upon" is taken from this Court's opinion in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971). *See Kaufman, Loss Causation*, 24 IND. L. REV. at 363 & n.48. Quoting *Huddleston*, 640 F.2d at 549, the Ninth Circuit stated the same rule in *McGonigle v. Combs*, 968 F.2d 810, 821 (9th Cir. 1992). *See also Nathenson v. Zonagen Inc.*, 267 F.3d 400, 413 n.10 (5th Cir. 2001) (defendants' actions need only "touch[] upon the reasons for the investment's decline in value").

> transaction. It is at that time that damages are to be measured. Thus, loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause.

339 F.3d at 938 (footnote omitted). Even though the court below did not cite Section 21D(b)(4) of the PSLRA, the rule the Ninth Circuit stated matched perfectly the explication of the "loss causation" rule offered in the Senate Report: "For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission." S. Rep. No. 104-98, at 15, *reprinted in* 1995 U.S. CODE CONG. & ADMIN. NEWS at 694.

In a footnote, the Ninth Circuit observed that some other circuit courts "do require demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint." *Id.* at 938 n.4 (citing the Third Circuit's decision in *Semerenko,* 223 F.3d 165). But, as set forth below, Respondents' allegations in this case were more than sufficient to satisfy even this (arguably) more stringent "loss causation" pleading standard.

In their Second Amended Complaint, Respondents asserted securities fraud claims on behalf of investors who purchased Dura securities, including common stock and subordinated notes, between April 15, 1997 and February 24, 1998 (the "Class Period"). JA 138a-139a.[20] During the

[20] This is the Class Period identified in Paragraphs 1 and 172 of Respondents' Second Amended Complaint; however, because Respondents' securities fraud claims against Petitioners were dismissed on a Rule 12(b)(6) motion, Respondents never moved for class certification. Following appropriate discovery, Respondents foreseeably could have

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Class Period, Petitioners – Dura and its high-ranking corporate officers – made false and misleading statements regarding the company's "Spiros" drug delivery device for the asthma medicine Albuterol (the "Albuterol Spiros Device"), and its "Ceclor CD" antibiotic. JA 34a-58a. Petitioners falsely claimed that completed testing showed the Albuterol Spiros Device was effective, that it was poised for approval by the U.S. Food & Drug Administration ("FDA"), and that it was expected to add $100 million in sales by 2000. In fact, Dura's clinical trials and in-house tests showed that the Albuterol Spiros Device was fatally flawed. Petitioners also falsely claimed that Ceclor CD sales were strong and increasing during the Class Period; however, Ceclor CD sales were dropping each quarter, with extra product clogging Dura's sales channels as Petitioners sought to revive flagging sales numbers. JA 48a-52a. *See Broudo,* 339 F.3d at 935-36 (summarizing Respondents' allegations and quoting from Petitioners' public statements indicating satisfactory development and testing of Albuterol Spiros Device and claiming rising sales of Ceclor CD, "both of which [Respondents] allege were known to [Petitioners] to be untrue").

Between June 1997 and February 1998, the four named Plaintiffs purchased shares of Dura stock at prices from $36.35 to $45.35 per share. JA 59a-60a. During the Class Period alleged in the Second Amended Complaint, Dura's

filed a motion to certify a different (*i.e.*, longer) Class Period. The federal courts have repeatedly recognized that they are "not bound by the class definition proposed in the complaint." *Robidoux v. Celani*, 987 F.2d 931, 937 (2d Cir. 1993); *see also Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 184-85 (1974) (Douglas, Brennan & Marshall, JJ., dissenting); 7B Charles Alan Wright, Arthur R. Miller & Mary Kay Kane, FEDERAL PRACTICE AND PROCEDURE: CIVIL 2D § 1700, at 270 (1986).

stock reached $52-1/4 per share (on October 8, 1997), an all-time high. JA 45a, 67a, 81a, 94a.[21] On February 24, 1998, Dura revealed that it expected lower-than-forecast 1998 revenues and earnings per share due to, *inter alia,* slower-than-expected sales of Ceclor CD. JA 51a, 110a-111a. Dura's stock price then dropped from $39.12 on February 24, 1998 to $20.75 on February 25, 1998, ***a 47% one-day loss*** marked by an unprecedented 32-million share trading volume. JA 51a. In contemporaneous published reports, securities analysts excoriated Petitioners, stating that "[m]anagement credibility has been severely damaged by this [earnings] announcement, particularly in light of recent investor conference presentations exuding confidence on the Company's fundamentals. . . ." JA 109a.[22]

Later, in an April 16, 1998 telephone conference call with stock analysts, Dura revealed that as early as December 1997, wholesale channels had been clogged with many months of excess inventory and that actual sales of several products, including Ceclor CD, had in fact been declining. JA 110a. Then, in November 1998, Dura revealed that the FDA had decided not to approve the

[21] Respondents allege that Petitioners took advantage of Dura's inflated stock price and profited handsomely from their scheme to defraud investors. In July 1997, Dura successfully completed a $287.5 million convertible note offering, the largest securities offering in the company's history. JA 92a. Two of the lead plaintiffs purchased 65 of those notes at a price of $1,000 each. JA 60a. Dura's insiders sold nearly 200,000 shares of their stockholdings, netting $7.27 million in proceeds. JA 120a-122a. Three months later, after Dura's stock price reached its all-time high, certain Petitioners again unloaded their stockholdings, netting $9.2 million in proceeds. JA 105a, 120a-122a. Thus, Respondents allege that Petitioners garnered over $300 million from securities offerings and insider bailouts.

[22] Over the ensuing months, Dura's stock price dropped another 40% on further bad news. *See* JA 54a (stock price chart).

Albuterol Spiros Device due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns. JA 110a, 111a; *Broudo,* 339 F.3d at 936. Even with the FDA's rejection announcement, however, Petitioners failed to truthfully disclose to investors the FDA's directive that further clinical trials must be conducted, prompting the FDA to issue a "notice of violation" to Dura three days later. The FDA notice stated that Dura had "misleadingly minimize[d] the fact that Dura must conduct a completely new clinical data [study]." JA 111a. Although Petitioners failed to reveal the complete truth about Dura's dealings with the FDA, even upon Petitioners' November 1998 revelations concerning the FDA's rejection of the Albuterol Spiros Device, Dura's stock price dropped ***another 21% in a single day***, from $12.37 to $9.75 per share. JA 156a.

AARP, NASCAT, and CFA submit that Respondents' allegations, taken as a whole, properly allege the "causation" and "damages" elements of their Section 10(b)/Rule 10b-5 claims. "Damages for securities fraud under § 10(b) or Rule 10b-5 need not be pleaded with specificity, particularly at the pleading stage of the litigation." *In re Credit Suisse First Boston Corp. Sec. Litig.,* 1998 U.S. Dist. LEXIS 16560, at *34, 1998 WL 734365 (S.D.N.Y. Oct. 19, 1998) (citation omitted). Under the well-settled rule followed in securities cases, the measure of damages is Respondents' and Class members' "out-of-pocket" loss, or the difference(s) between the price(s) they paid for Dura securities and the value of securities received at the time of their purchase(s).[23]

[23] *See, e.g., Randall v. Loftsgaarden,* 478 U.S. 647, 662 (1986); *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 155 (1972); *Ambassador Hotel,* 189 F.3d at 1030; *Wool v. Tandem Computers, Inc.,* 818 F.2d 1433, 1437 (9th Cir. 1987) ("out-of-pocket" rule fixes recoverable damages

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At trial, and on a complete evidentiary record – including "event studies" prepared by expert witnesses – the trier of fact will determine the amount of damages, if any, Respondents are entitled to recover.[24] But "[t]hese are all

as "the difference between the purchase price and the value of the stock at the date of purchase") (citation omitted). The principle underpinning this rule is that plaintiff's injury is not the loss of what he or she might have gained if the false facts had been true, but rather what he or she has actually lost by being deceived into the purchase. *See Wool*, 818 F.2d at 1437 n.2; *see also* Jay W. Eisenhofer *et al., Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 BUS. LAW. 1419, 1424-28 (2004).

The "out-of-pocket" measure of damages is traceable to *Sigafus v. Porter*, 179 U.S. 116 (1900), where plaintiff was fraudulently induced to invest in a gold mine whose value had been exaggerated by defendant. "[T]he loss, in the transaction before us, is the difference between the real value of the stock at the time of the sale, and the fictitious value at which the buyer was induced to purchase. . . . " *Id.* at 124 (citation omitted). Justice Harlan wrote that the "same principle was recognized" by the English Court of Appeal in *Peek v. Derry*, 37 Ch. Div. 541 (1889), an action to recover damages for defendant's fraudulent representations whereby plaintiff was induced to take shares in a certain company at the price of £ 4000:

> The question of the proper measure of damages in such a case was directly presented and considered. Lord Justice Cotton said: "The damage to be recovered by the plaintiff is the loss which he sustained by acting on the representations of the defendants. That action was taking the shares. Before he was induced to buy the shares, he had the £ 4000 in his pocket. The day when the shares were allotted to him, which was the consequence of his action, he paid over that £ 4000, and he got the shares; and the loss sustained by him in consequence of his acting on the representations of the defendants, was having the shares, instead of having in his pocket the £ 4000. The loss, therefore, must be the difference between his £ 4000 and the then value of the shares."

179 U.S. at 124.

[24] In his concurring opinion in *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1341 (9th Cir. 1976), Judge Sneed set forth a milestone theory for calculating damages, postulating that in any securities fraud

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matters for the factfinder on a fully-developed record." *DeMarco*, 318 F. Supp. 2d at 124 n.6.[25]

In this case, the Ninth Circuit held that Respondents had satisfied the "loss causation" element of their securities fraud claims by alleging that Dura's stock price was overstated at the time of their purchases and providing "sufficient identification" of the cause for this overvaluation; namely, Petitioners' material misrepresentations and omissions concerning the Albuterol Spiros Device and Ceclor CD sales. *Broudo*, 339 F.3d at 939. Under well-settled precedent, Respondents would satisfy the "loss causation" requirement by pointing to a subsequent stock price drop. *See Blackie*, 524 F.2d at 909 n.25. They will then have shown that Petitioners' misleading statements "touch upon" the reasons for the stock's later decline in value. *See Provenz v. Miller*, 102 F.3d 1478 at 1492. But while a drop in price upon corrective disclosure "is of course circumstantial evidence of the inflation when

class action, the best way to measure the loss proximately caused by defendant's misrepresentation is to create a chart containing a "price line" and a "value line." Under this method, damages are calculated by subtracting the true value of the stock on the date of purchase from the price actually paid, with the spread between the price and value lines varying over time.

[25] Under Section 21D(e)(1) of the PSLRA, the damages awarded in any securities fraud action "shall not exceed the difference between the purchase . . . price paid . . . by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market." 15 U.S.C. § 78u-4(e)(1). Although the relevant "mean trading price" of Dura stock has not been established, and the issue was not briefed or discussed in the court below, Respondents have calculated that the "mean trading price" was $12.96. Respondents paid more than double this approximated "mean trading price" for their Dura stock.

purchased, . . . it is not the exclusive method of measuring inflation." *Blackie,* 524 F.2d at 909 n.25.

Decisions from other circuit courts demonstrate that Respondents' allegations in this case were more than sufficient. In *Gebhardt,* 335 F.3d at 827, the investors' class action alleged that United Agri Products ("UAP"), a wholly-owned subsidiary of ConAgra Foods, engaged in misleading accounting practices, thereby causing UAP's (and, hence, ConAgra's) earnings statements to be overstated. In May 2001, ConAgra announced that, due to UAP's subterfuge, it was going to have to restate its past and present earnings. The company's stock price dropped by about 4% the day after the announcement. *Id.* Reversing the district court's dismissal of the case due to the investors' purported failure to allege "loss causation," the Eighth Circuit stated in relevant part:

> The plaintiffs also demonstrated loss causation by pleading that a decline in the value of their stock was related to UAP's accounting issues. They did plead this, and the stock declined by roughly 4 per cent the day after the May announcement. This was a sufficient allegation of a causal link between the company's misbehavior and a subsequent decline. . . .

Id. at 831. On appeal, ConAgra argued that because its stock's value increased in the weeks following the May 2001 announcement, plaintiffs could "show no connection between the misrepresentations and any loss." *Id.* In a passage that is relevant to this case, the Eighth Circuit rejected this contention on substantive and procedural grounds:

> [S]tockholders can be damaged in ways other than seeing their stocks decline. If a stock does not appreciate as it would have absent the fraudulent conduct, investors have suffered a harm. Therefore, we decline to attach dispositive significance to the stock's price movements absent sufficient facts and expert testimony, which cannot be considered at this procedural juncture, to put this information in its proper context.

Id. at 831-32.

In *Semerenko,* the case cited by the Ninth Circuit in footnote 4 of its decision, the Third Circuit equated "loss causation" with proximate cause, stating that there must be a "sufficient causal nexus between the loss and the alleged misrepresentation." 223 F.3d at 184. In that case, plaintiffs alleged that they purchased shares at a price that was inflated due to misrepresentations made by several corporate officers and directors and that, when the truth was made known, the company's stock price dropped to its true value. *Id.* at 185. As in this case, the investors' complaint in *Semerenko* alleged that defendants' misrepresentations

> directly or proximately caused, or were a substantial contributing cause of, the damages sustained by plaintiff and the other members of the Class. The misstatements . . . had the effect of creating in the market an unrealistically positive assessment of Cendant, as well as of its financial condition, causing ABI's common stock to be overvalued and artificially inflated at all relevant times.

Id. at 186. Defendants urged that plaintiffs did not adequately plead "loss causation" but the Third Circuit rejected that argument, finding that these allegations adequately pled this element. *Id.; see also EP Medsystems,* 235 F.3d at 883-85 (discussing and following *Semerenko*).

Other circuit courts have reached the same result when analyzing similar securities fraud "loss causation" allegations. *See Emergent Capital,* 343 F.3d at 197-99 (holding that allegations of a "pump and dump scheme," in

which defendants allegedly inflated a security's market price so that they could sell shares before it fell, provided a sufficient connection between defendants' misrepresentations and plaintiffs' losses); *see also Suez Equity Investors,* 250 F.3d at 97-98; *Caremark,* 113 F.3d at 649-50. In addition, a legion of recent district court decisions construing and applying Section 21D(b)(4) of the PSLRA have reached the same conclusion. *See, e.g., Enron,* 310 F. Supp. 2d at 832 (holding that investors' amended complaint "does allege the requisite loss causation between plaintiffs' alleged economic loss and the acts, misrepresentations, missions, and/or concealment of the realities underlying the sham financial reports and image of success projected by Enron and co-Defendants").[26]

[26] *See also Crowell v. Ionics, Inc.*, 2004 U.S. Dist. LEXIS 22254, at *62, 2004 WL 2475332 (D. Mass. Nov. 3, 2004) ("The pleading burden for [loss causation] is only a 'minimal burden,' much less than the 'strong inference' requirement for scienter, and can be satisfied by alleging that the Ionics Defendants' misstatements artificially inflated the price of Ionics common stock during the class period.") (footnote and citations omitted); *In re Initial Public Offering Sec. Litig.*, 2004 U.S. Dist. LEXIS 20552, at *61-65, 2004 WL 2320364 (S.D.N.Y. Oct. 15, 2004) (refusing to dismiss securities fraud complaint on "loss causation" grounds); *Johnson*, 2004 U.S. Dist. LEXIS 14986, at *54 ("Plaintiff alleges he would not have purchased the DCX stock if he was aware of this artificial [stock price] inflation. Plaintiff's allegations satisfy the causation pleading requirement. . . ."); *In re Stellent, Inc. Sec. Litig.*, 2004 U.S. Dist. LEXIS 14152, at *35 n.7, 2004 WL 1646500 (D. Minn. July 23, 2004) ("The entire Amended Complaint is premised on the allegation that Stellent's stock plummeted as the truth about the company's dubious transactions became known. This is loss causation, classically pled, and does not require the company to have restated revenues.") (citation omitted); *In re Tyson Foods, Inc. Sec. Litig.*, 2004 U.S. Dist. LEXIS 1112[illegible], at *35-36 (plaintiffs adduced sufficient evidence of "loss causation" to withstand defendants' summary judgment motion); *Fogarazzo*, 2004 U.S. Dist. LEXIS 9193, at *40-41 ("plaintiffs here have adequately alleged that the Banks' misrepresentations caused their loss . . . the Banks are alleged to have lied about

(Continued on following page)

IV. CONCLUSION

AARP, NASCAT, and CFA submit that the Ninth Circuit correctly found that Respondents properly alleged the "loss causation" element of their Section 10(b)/Rule 10b-5 claims. For the reasons stated herein, if this Court reverses the decision of the court below and accepts Petitioners' misguided construction of the PSLRA's "loss causation" provision, it will make it much more difficult – if not impossible – for defrauded investors who have been victimized in the above-referenced multi-billion dollar securities frauds to recover their out-of-pocket losses. Any such result will further diminish investors' confidence in our securities markets.

the financial health and future prospects of RSL – namely, the investment quality of RSL securities . . . RSL ultimately failed because of the very facts that the Banks misrepresented: that RSL was in financial trouble and that the entire 'internet telephony sector' was collapsing"); *AOL Time Warner*, 2004 U.S. Dist. LEXIS 7917, at *97 ("the Amended Complaint quite clearly alleges losses caused by a disparity between the transaction price and the true investment value of AOL and AOLTW. As such, loss causation is properly pled. . . .") (footnote omitted); *DeMarco v. Lehman Bros.*, 309 F. Supp. 2d 631, 636 (S.D.N.Y. 2004) ("assuming arguendo that plaintiffs must plead that their losses resulted from the marketplace's reaction to the revelation of the truth that defendant's actionable statements concealed (as contrasted to independent market forces), the Complaint adequately alleges that in or around October, 20[illegible]0 the market was finally apprised of the negative information concerning RealNetworks . . . and that, as the result of those revelations, the stock declined, causing the losses on which plaintiffs here sues"); *Electronic Data Sys.*, 298 F. Supp. 2d at 560 ("Defendants' misrepresentations inflated the stock value such that the stock value decreased when investors learned of the problems with the NMCI Contract").

DATED: November 12, 2004

Respectfully submitted,

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Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF STATE OF NEW JERSEY DEPARTMENT OF THE TREASURY AND ITS DIVISION OF INVESTMENT AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICUS CURIAE[1]

The State of New Jersey Department of the Treasury and its Division of Investment ("Division"), with $79.4 billion invested in the public markets under management, is among the 50 largest public or private money managers in the United States. The pension funds constitute $67.5 billion of the Division's managed assets, which represent the retirement plans for over 700,000 active and retired employees. The remaining monies are managed in over 170 additional separate funds, such as the NJ Cash Management Fund, the Deferred Compensation Fund, the Supplemental Annuity Collective Trust Fund and a portion of the NJBEST College Savings Plan.

As a large public institutional investor, the Division and the investors and pensioners it serves have a great interest in the proper interpretation and enforcement of the securities laws. The issue raised in this case – the standard for pleading loss causation in securities fraud actions – is of great importance to investors. Additionally, the Division currently serves as lead plaintiff in six pending securities class actions, and the Court's decision on loss causation in this matter may bear directly on those suits, even those in which the pleading stage has passed.

Accordingly, it is respectfully submitted that the Division's views can assist the Court in considering this matter.

---

1. Pursuant to this Court's Rule 37.6, the State of New Jersey Department of the Treasury and its Division of Investment states that no counsel for any party authored this brief in whole or in part, and no person or entity other than amicus curiae, or its counsel, has made a monetary contribution to the preparation or submission of brief. Pursuant to Rule 37.3, the parties' letters of consent to the filing of this brief have been lodged with the Clerk.

INTRODUCTION

This case is about pleading. It is not, as petitioner's supporting amici would have one believe, about the efficacy of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), nor is it one in which this Court is called upon to divine congressional intent from an ambiguously worded statute. In passing the PSLRA, Congress created a detailed and complex legislative scheme to accomplish its goals, including a heightened pleading standard for certain elements of securities fraud claims. Congress did not say that loss causation must be pleaded and it did not define how to do so. Stripped of hyperbole and freed from the specter of "frivolous litigation," the question presented in this case may be resolved by simple adherence to the time-tested rules of pleading and study of the common law conception of loss causation's twin – proximate cause.

ARGUMENT

I. The Role of Private Securities Litigation

It has long been recognized that private litigation serves as a "necessary supplement" to public enforcement of the securities laws. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). According to the congressional testimony of then-Securities and Exchange Commission ("SEC") Chairman Arthur Levitt, "Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws." *Common Sense Legal Reform Act: Hearing Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong. 1 (1995) (prepared statement), *available at* http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt (last visited Nov. 13, 2004).

Congress enacted the PSLRA, Pub. L. No. 104-67, 109 Stat 737, codified at 15 U.S.C. § 77z-1 to 78u-5, to remedy perceived

abuses in securities litigation. In so doing, Congress emphasized the important continuing role of private plaintiffs in enforcing the nation's securities laws:

> Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and other properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.

H.R. Conf. Rep. No. 104-369, at 31-32 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 730-31. In the wake of recent accounting scandals in 2001 and 2002, Congress reiterated the importance of private securities actions when enacting the Sarbanes-Oxley Act of 2002 which, among other reforms, extended the statute of limitations for securities fraud cases. *See* Pub. L. No. 107-204, Title VIII, § 804(a)(b) and (c).[2]

Private enforcement is necessary to our current system of regulation because, as has been widely reported, the SEC does not have the resources to police the entire market. *See* United States Gen. Accounting Office, *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302, at 33 (Mar. 5, 2002), *available at* http://www.gao.gov/new.items/d02302.pdf. The New York Times has reported that the SEC is plagued by

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2. Contrary to the argument of Amicus American Institute of Certified Public Accountants, Brief of the AICPA at 25, nothing in the Sarbanes-Oxley Act implies that it was intended to *replace* private action; to the contrary, the extended statute of limitations implies that Congress hoped to *increase* opportunities for private litigation.

high turnover and insufficient resources to conduct the kinds of diligent reviews necessary to ensure against fraudulent filings. *See* Stephen Labaton, *SEC Is Suffering Nonbenign Neglect*, N.Y. Times, July 20, 2002, at B1.

Despite the longstanding reliance on private litigants to shoulder a significant share of the burden of policing the securities markets, many of the briefs submitted by amici contend that the loss causation provision of the PSLRA is intended to alleviate congestion in the federal courts by imposing a drastically heightened burden at the *pleading* phase of any securities fraud action. Such congestion is proved by, among other things, what amici perceive as the large number of securities fraud actions filed in recent years. These arguments read as though the past three years of high-profile corporate scandals never occurred. No mention is made of the fact that 2001 through 2003 saw seven of the ten largest bankruptcies in this country's history – including Worldcom, Enron, Global Crossing, and Adelphia – of which at least three have led to criminal prosecutions for accounting fraud. *See Largest Bankruptcies, 1980-Present*. Infoplease (Nov. 16, 2004) *available at* http://www.infoplease.com/ipa/A0904494.html (last visited on Nov. 16, 2004). Nor is there mention that the Food and Drug Administration has become so concerned about biotechnology companies overstating the prospects of approval of new products that it has been working with the SEC to set aside its traditional secrecy about pending applications in order to prevent securities law violations. *See* Ross Kerber, *Regulators Outline Actions to Oversee Drug Firms' Claims: FDA, SEC Would Share Information*, Boston Globe, Feb. 6, 2004, at C3. Nor is any mention made of the fact that some of the most prominent names on Wall Street have recently been repeatedly entangled by SEC and other investigations involving fraudulent

accounting practices,[3] the undue influence of investment banking interests on securities research,[4] and fraudulent initial public offerings allocation practices.[5] In other words, amici overlook the most obvious explanation for any increases in litigation during the past few years: an increase in the occurrence of securities fraud.

Given continued congressional reliance on private enforcement of the securities laws and the recent exposures of extensive corporate malfeasance, it is not appropriate to interpret every provision of the PSLRA as though it was intended to heighten plaintiffs' burden at the outset of a case and facilitate dismissals on the pleadings. Rather, the PSLRA has a number of different provisions, all intended to affect different stages of litigation. Although the PSLRA does contain specific provisions intended to impose heightened pleading burdens, these provisions are clearly identified by the statutory text, and the loss causation provision is not among them.

II. The Scheme of the PSLRA

A. The PSLRA's Multiple Reforms are Targeted at Distinct Phases of Litigation

The PSLRA effected a wholesale reconfiguration of the procedures in securities lawsuits, from the very first filings of a complaint through to liability and damages limitations and settlement procedures.

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3. *E.g.*, The SEC Charges Merrill Lynch, Four Merrill Lynch Executives with Aiding and Abetting Enron Accounting Fraud, Accounting and Auditing Enforcement Act Release No. 1742, 79 S.E.C. Docket 2533 (Mar. 16, 2003).

4. *E.g.*, SEC Sues Merrill Lynch and Henry M. Blodget for Research Analyst Conflicts of Interest: firm and Blodget Settle With SEC, NASD, and NYSE, Release No. 18115, 80 S.E.C. Docket 319 (Apr. 28, 2003).

5. *E.g.*, *SEC v. Credit Suisse First Boston Corp.*, [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91, 695 at 98, 123 (D.D.C. Jan. 29, 2002).

With respect to the initiation of a securities class action, the PSLRA created a set of procedures for determining which investor will serve as the lead plaintiff, with the express purpose of encouraging institutional investors, such as pension funds, to take a more active role in the litigation. 15 U.S.C. § 78u-4(a)(3)(B).[6] The statute places limits on the use of "professional plaintiffs" by forbidding any single plaintiff from serving as lead more than five times in a three-year period, 15 U.S.C. § 78u-4(a)(3)(B)(vi), and forbids the lead plaintiff from receiving compensation over and above that received by other class members, 15 U.S.C. § 78u-4(a)(4).

The lead plaintiff selects lead counsel for the Class, 15 U.S.C. § 78u-4(a)(3)(B)(v), and, typically, files a new consolidated complaint that will govern the action. *See generally* Clifford Chance LLP, *Defending Securities Class Actions*, SH083 ALI-ABA 177 (2003). Certain statutory provisions are aimed at complaints, specifically: the PSLRA provides that a complaint must not only specifically identify false statements and the reasons why they are false, but, for allegations made on information and belief, the complaint must "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). For allegations of scienter, the pleading requirements are even more stringent: "the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

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6. A recent survey by PricewaterhouseCoopers shows that this effort has been successful. The rate of unions and public pension funds appointed as lead plaintiffs has grown steadily from 1996 to 2003. *See* PricewaterhouseCoopers LLP, *2003 PricewaterhouseCoopers LLP Securities Litigation Study* 6, (*available at* http://www.10b5.com.)

Additionally, the PSLRA imposes a stay of discovery until the resolution of any motions to dismiss. 15 U.S.C. § 78u-4(b)(3)(B). Thus, plaintiffs must meet these heightened pleading requirements without any formal access to internal corporate documents or the testimony of employees. Notwithstanding this fact, courts have often stated that plaintiffs must identify specific internal reports and their contents. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 942 n.20 (9th Cir.) (disregarding allegations of the existence of internal reports because precise contents not alleged), *cert. denied*, 124 S. Ct. 433 (2003); *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000) ("Where plaintiffs contend defendants had access to contrary facts, they must specifically identify the reports or statements containing this information.").

Once a complaint has survived a motion to dismiss, the case moves into discovery and the class certification stage.[7] After the class has been certified the PSLRA permits courts to require an undertaking from the parties or their counsel to ensure the payment of any fees or expenses that may be awarded. 15 U.S.C. § 78u-4(a)(8).

The statute goes on to impose certain substantive requirements as the case is developed. Plaintiffs must "prove" loss causation, 15 U.S.C. § 78u-4(b)(4), and projections or forecasts of future performance are immunized unless the plaintiff proves that they were made with "actual knowledge" of their falsity, 15 U.S.C. § 78u-5(c)(1), heightening the standard over the recklessness that would ordinarily satisfy the scienter

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7. A recent amendment to the Federal Rules of Civil Procedure provides that a court of appeals, in its discretion, may permit an immediate appeal from an order of the district court granting class certification. Fed. R. Civ. P. 23(f); *see, e.g.*, *Hevesi v. Citigroup Inc.*, 366 F.3d 70 (2d Cir. 2004).

requirement, *see, e.g., Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996).

In the trial phase, the statute grants defendants the right to request written interrogatories of the jury on the question of scienter at the time of the violations, 15 U.S.C. § 78u-4(f)(3).

At the conclusion of litigation, the PSLRA controls damage awards and settlements. The statute replaces the old scheme of joint and several liability with a scheme of proportionate fault, 15 U.S.C. § 78u-4(f), and if some, but not all, defendants settle, the statute requires the entry of an order barring contribution claims made by or against the settling defendants, 15 U.S.C. § 78u-4(f)(7). In the "lookback" provision, damages awarded to any single plaintiff are capped at the difference between the price paid and the "mean trading price" of that security in the 90 days following a corrective disclosure. 15 U.S.C. § 78u-4(e). Proposed settlements must be communicated to the Class in great detail, including the per-share settlement amount and the expected per-share award if plaintiffs prevailed at trial. 15 U.S.C. § 78u-4(a)(7).

Finally, the PSLRA provides that attorneys' fees may not exceed a reasonable percentage of amounts actually paid to the Class. Upon completion of the litigation, the court is specifically directed to review the conduct of the attorneys and impose any appropriate sanctions under Rule 11. 15 U.S.C. § 78u-4(c).

B. The PSLRA has Substantially Altered Private Securities Litigation

The PSLRA has had a major impact on the practice of securities law, particularly at the pleadings stage, where plaintiffs are required to draft highly-detailed complaints without benefit of discovery. As a practical matter, plaintiffs often rely on employees and former employees of the defendant corporation – limited by a patchwork of state laws regarding the

permissibility of such contacts[8] – who are willing to come forward and discuss what they know, or supply plaintiffs with documentary evidence of their claims. *See, e.g., ABC Arbitrage v. Tchuruk*, 291 F.3d 336, 352-54 (5th Cir. 2002); *Novak*, 216 F.3d at 313. As a result of these stringent requirements, it is common for even very detailed complaints to be dismissed on the pleadings. *See, e.g., Goldstein v. MCI Worldcom*, 340 F.3d 238 (5th Cir. 2003) (affirming dismissal of securities fraud complaint against Bernard Ebbers and Scott Sullivan of Worldcom for failure to plead that the defendants acted with intent); *In re Tyco Int'l, Ltd. Sec. Litig.*,, 185 F. Supp. 2d 102 (D.N.H. 2002) (dismissing securities fraud complaint against Tyco as insufficiently detailed).

Indeed, even when plaintiffs supply statements from witnesses and documentary evidence in support of their claims, there is no guarantee that the complaint will survive a motion to dismiss. *In re Cabletron Systems, Inc.*, 311 F.3d 11 (1st Cir. 2002), for example, involved a review of a district court's decision to dismiss a complaint containing information from several former employees who claimed to have been aware of specific fraudulent practices, including the invention of fictitious sales. *Nursing Home Pension Fund, Local 144 v. Oracle Corporation*, 380 F.3d 1226 (9th Cir. 2004), examined a district court's dismissal of a complaint that included statements from at least 44 confidential witnesses, documentary evidence, and

8. For instance, some states place limits on contacts with former employees who were members of the corporate control group or whose actions underlie the lawsuit, *see, e.g.*, South Carolina Bar Ass'n Ethics Advisory Op. 92-31 (1992); South Carolina Bar Ass'n Ethics Advisory Op. 94-25 (1994); *Lang v. Superior Court*, 826 P.2d 1228 (Ariz. Ct. App. 1992); *Porter v. Arco Metals Co.*, 642 F. Supp. 1116 (D. Mont. 1986), other states place no such limits, *see, e.g., Cram v. Lamson & Sessions, Co.*, 148 F.R.D. 259 (S.D. Iowa 1993); *Fulton v. Lane*, 829 P.2d 959 (Okla. 1992).

expert financial analysis. Both of these decisions were reversed on appeal, but only after extensive litigation; moreover, the federal reporters contain several similar examples for which no appeal was apparently taken, or in which dismissals were affirmed on appeal. *See, e.g., Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353 (5th Cir. 2004) (actions based on public corporate documents, such as press releases, must identify which particular individuals drafted or approved the documents and allege facts demonstrating that such individuals acted with intent to defraud); *In re Nike, Inc. Sec. Litig.*, 181 F. Supp. 2d 1160 (D. Or. 2002) (despite allegations of specific reports demonstrating internal problems, complaint dismissed for failure to plead "corroborative facts"); *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308 (M.D. Fla. 2002) (concluding that complaint does not sufficiently describe various situations in which defendants were said to have been advised of the financial problems).

The PSLRA also works in tandem with this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994) to make it difficult to bring actions against accountants, attorneys, and other peripheral actors. *See Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1206 (11th Cir. 2001) (holding that auditors will not be liable for false statements that they played a role in drafting or editing if the statements are not publicly attributed to the auditor). A typical view was expressed in *In re SCB Computer Tech., Inc., Sec. Litig.*, 149 F. Supp. 2d 334 (D. Tenn. 2001),

> [T]he lack of a rational economic incentive for an independent accountant to participate in fraud, the client's central role in providing information to the accountant, and the complex professional judgment required to perform an audit, make it exceedingly difficult for a securities plaintiff to plead facts

> suggesting that an independent accountant acted with the deliberate state of mind now required to withstand a motion to dismiss.

Id. at 356 (citation omitted).

In short, as one court described it, under the PSLRA, "the gamesmanship required to plead a successful securities claim has taken on a dimension reminiscent of pre-Federal Rules pleading practice." *In re Number Nine Visual Tech. Corp. Sec. Litig.*, 51 F. Supp. 2d 1, 27-28 n.22 (D. Mass. 1999).

The practical effect is that since the enactment of the PSLRA, motions to dismiss are granted with far more frequency. According to two studies, dismissal rates have doubled since the PSLRA took effect. *See* Richard Painter et al., *Private Securities Litigation Reform Act: A Post-Enron Analysis* 7-8, The Federalist Society for Law & Public Policy Studies (June 2002), *available at* http://www.fed-soc.org/pdf/PSLRAFINALII.PDF (last visited Nov. 16, 2004). Moreover, courts have observed that the high pleading standards coupled with the discovery stay have made "motions to dismiss in securities fraud cases . . . all too common where the procedural posture of the case renders most of the defendants' arguments futile." *In re Indep. Energy Holdings PLC Sec. Litig.*, 154 F. Supp. 2d 741, 747 (S.D.N.Y. 2001). A typical securities fraud action may not even begin discovery until two years after the initial filing. *See* Terrence G. Stolly, Comment, *Scienter Under the Private Securities Litigation Reform Act of 1995: Unexpected Implications on Director and Officer Liability and D&O Insurance*, 29 Cap. U. L. Rev. 545, 577 (2001). It is against this backdrop that the PSLRA's loss causation provision must be considered.

III. Loss Causation

A. Proximate Cause Requires Only that the Loss Touch Upon the Fraud

The circuits agree that "loss causation" in securities law is similar to the common law concept of proximate cause, and requires only that the plaintiff show that "the misrepresentation touches upon the reasons for the investment's decline in value." *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983). Loss causation requires that "the damages suffered by plaintiff [] be a foreseeable consequence of any misrepresentation or material omission." *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 186 (2d Cir. 2001).

i. Loss causation is shown if the truth is disclosed to the market

The United States is clearly correct by arguing that loss causation is properly alleged when the artificial inflation is removed from the stock price, typically when the "truth" is revealed to the market either through an actual revelation of fraud, or simply by the fact that the corporation's true financial condition becomes apparent. Brief of United States as Amicus Curiae at 19-21. When one lies about a company's financial condition and inflates the price of the stock, it is always foreseeable that artificial inflation will dissipate when the truth comes out, whether that occurs through a large announcement of a sudden loss, or a series of smaller disclosures over time that provide counterbalancing truthful information about the company.

The case of *In re Control Data Corp.*, 933 F.2d 616 (8th Cir. 1991), illustrates this principle. The company

admitted that it had overstated its earnings, but its announced restatement did not affect the price of the stock. However, after the *Wall Street Journal* pointed out that the new, revised numbers left the company in violation of its loan covenants, its stock price dropped $3 per share. The district court determined that the $3 price drop was attributable not to the fraud, but to the company's failure to disclose its default on the loan covenants. Because the company had no freestanding obligation to disclose the loan covenant status, there was no causation. *See id.* at 617-18.

The Eighth Circuit reversed. In the Eighth Circuit's view, although the earnings overstatement itself may not have caused investors' losses, the false accounting obscured the status of the company's loan covenants. *See id.* at 620. Once the market became aware of the underlying reality of the company's financial condition, the stock price fell. These losses were recoverable.

By contrast, the court erred in *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 273 F. Supp. 2d 351 (S.D.N.Y.), *appeal docketed*, No. 03-9286 (2d Cir. Dec. 1, 2003). There, the plaintiffs alleged that the brokerage firm of Merrill Lynch issued false research reports on various stocks, thus causing the stock prices to rise. When the stock prices crashed, the plaintiffs lost their investment. *See id.* at 359. The district court dismissed the claims on the ground that the chain of causation was broken by the "intervening cause" of the burst of the stock market bubble. *See id.* at 364-65. What the district court apparently failed to realize is that a "burst bubble" is, in reality, a collective realization by the market that a large number of stocks were overvalued relative to their true earnings potential. In other words, a burst bubble is not an unforeseen, unrelated event, like a terrorist attack or an

earthquake, but is simply a shorthand term for disclosure of the truth. Because it is always foreseeable that truth will eventually be revealed, the district court erred in concluding that no loss causation had been shown.

ii. Loss causation is shown if the fraud facilitates the events that cause the decline in value

There are other ways in which a plaintiff might show that the fraud "touches upon" their losses, even if whatever artificial inflation the false statement caused continues to provide a boost to the stock price and has not dissipated merely due to the disclosure of truthful information. For instance, in the traditional manner that proximate cause has always been conceived, the fraud may directly lead to a chain of events which then become the immediate cause of plaintiffs' losses. *See Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) (loss causation requires showing a "causal link" between the misrepresentation and the harm suffered).

The case of *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000), provides a useful example. The Cendant corporation issued a tender offer for the shares of American Bankers Insurance Group (ABI). The market reacted favorably to the news and ABI's stock price increased. Later, Cendant discovered that its financial statements had been fraudulently inflated, and ABI and Cendant jointly announced that the merger would be terminated. *See id.* at 171. ABI's stock price collapsed and ABI shareholders sued Cendant. Cendant insisted that there was neither transaction causation nor reliance, because the direct causes of both the price inflation in ABI stock, and its subsequent collapse, were the decisions to arrange for a merger and to cancel it. *See id.* at 186-87.

The Third Circuit disagreed, explaining that "not every intervening event is sufficient to break the chain of causation." *Id.* at 186; *see id.* ("to allow any intervening change in market conditions not directly caused by the defendant to break the chain of causation and exempt the defendant from liability would eviscerate Rule 10b-5" (citation omitted)). In the Third Circuit's view, the collapse in share price would still have been "caused" by Cendant's fraud if, instead of affecting ABI shares directly, it had led the ABI Board of Directors to conclude that the merger would no longer be beneficial to the company – a decision which, in turn, caused the price collapse. *See id.* at 187.

By contrast, the principle was misapplied in *Robbins v. Koger Properties*, 116 F.3d 1441 (11th Cir. 1997). Koger's accountant, Deloitte, was alleged to have fraudulently certified financial statements that overstated Koger's cashflow. Because Koger paid its cashflow out in dividends, the overstated cashflow led to high dividends and an increase in its stock price. *See id.* at 1444. To maintain these high dividend payments, Koger began selling its assets, which eventually caused its stock to decline during the Class Period. *See id.* at 1444-45. The stock ultimately crashed when Koger cut its dividend. *See id.* at 1445.

The Eleventh Circuit held that there had been no loss causation because the market was still under the mistaken impression that Koger's financial statements had been accurate at the time of the crash, and because it was Koger's inability to sell more of its assets, rather than the overstated cash flow, that led to the dividend cut. *See id.* at 1448-49. This was far too narrow a view of causation.

As the opinion makes clear, Koger's stock price steadily declined as it sold its assets to maintain its dividends. But

its high dividend rate was a direct result of the overstated cash flow approved by Deloitte. In other words, Deloitte's fraud enabled Koger to take the actions that ultimately harmed investors.[9] As for the dividend cut at the end of the Class Period, that too flowed from Koger's financial instability caused by its continuing sale of assets to maintain its dividends. Koger's financial instability was therefore an entirely foreseeable consequence of its creation of fictional cashflow, all of which had been approved by Deloitte. Thus, the "fact misstated was of a nature calculated to bring about such a result that damages for it can be recovered." *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 718 (2d Cir. 1980) (quotation omitted).

iii. Loss causation is shown if the artificial inflation is no longer recoverable

Finally, the loss must be deemed to have been caused by the fraud if the value of the security has dropped to the point where any artificial inflation in the stock price cannot be recouped through a resale; that is, where the price of the stock has fallen below the amount of the artificial inflation itself (even to the point of insolvency of the company). In that case, whatever portion of the stock price was attributed to the artificial inflation has been removed and is unrecoverable; necessarily, the fraud "touches upon" the investor's loss, and the element of loss causation has been satisfied. Indeed, the United States agrees that so long as the investor may recoup her losses through a resale of the stock, there is no loss

9. This analysis assumes that the United States is correct in concluding that the decline in Koger's stock price as its financial position deteriorated was not simply a method by which the "truth" became known to the market. Brief for United States at 17.

causation, Brief for United States at 21; by the same token, when a resale will no longer permit recoupment, there is loss causation.

The PSLRA itself envisions something similar, as evidenced by its "lookback" provision regarding damages. 15 U.S.C. § 78u-4(e). The "lookback" provision largely codifies the insights of Baruch Lev and Meiring de Villiers in their article *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 Stan. L. Rev. 7 (1994). Lev and de Villiers argued that the then-current method of damage calculation, which assumed that the "true worth" of a company was measured by its share price immediately following a corrective disclosure, substantially undervalued the company and, consequently, overestimated plaintiffs' damages. In their view, certain inefficiencies in trading cause markets to overreact to corrective disclosures with a brief "crash" in stock price, followed by a bounceback to a more appropriate share price, as measured by the true fundamentals of the company. *See id.* at 15-16. They recommended that plaintiffs in shareholder class actions receive damages based not on the share price immediately following disclosure, but instead after a short waiting period, to allow the stock to settle at its true value. *See id.* at 35-36. The PSLRA's legislative history explicitly cites the Lev and de Villiers article. *See* S. Rep. No. 104-98 at 20 & n.58, 104th Cong, 1st Sess 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679.

The lookback provision, then, addresses the problem of market overreaction to announcements of adverse information, and is intended to ensure that shareholders are not compensated for damages that are not attributable to

the fraud, but are instead attributable to residual market inefficiencies.[10] *See* Lev & de Villiers, at 22-23.

Significantly, however, the PSLRA provision has an exception not recommended by Lev and de Villiers: Shareholders who sell their stock before the end of the lookback period *will* recover some of these "crash" damages because the lookback period is shortened for them. 15 U.S.C. § 78u-4(e)(2). Under this exception, a plaintiff who sells immediately after the adverse information is released will recover the full amount of her loss, even though some of that loss was, by hypothesis, caused by the "intervening" event of market inefficiencies.

In other words, Congress reached a fair compromise. Shareholders whose losses are due to intervening causes – *i.e.*, market overreaction – may not recover for those losses *when the market itself* will restore the value to the shares. But where those shareholders' losses are permanent because the stock has been disposed of, then Congress is unwilling to let the burden of the loss fall entirely upon the innocent victim of the fraud, rather than its perpetrator, and at least some damages for the "intervening" event will be awarded. *See* Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. Chi. L. Rev. 879, 897-98 (1998). The situation is therefore similar to one in

10. Notably, the statute does not express any view as to how the market might become aware of a corporation's actual value; the statute merely refers to "information correcting the misstatement or omission." 15 U.S.C. § 78u-4(e)(1). This noncommittal phrasing could refer to a formal announcement, business developments that affect the company, or the gradual release of truthful information about the company's financial condition.

which the artificial inflation is removed from the stock because the stock's price has dropped below the point where overpayment can be recouped through a resale. The market itself can no longer compensate the shareholder and the loss is permanent; at that point, it is the wrongdoer, and not the victim, who must pay the price for the fraud.

B. Petitioner and Amici Confuse Revelation of the Fact of Falsity with Loss Caused by the Fraud

Some amici have argued that losses cannot exist unless there is a formal revelation of the false statements followed by an immediate drop in stock price. In so doing, they confuse revelation of the *fact* of the fraud with the losses caused by the fraud. There are any number of factors that could cause losses to investors while simultaneously preventing the stock market from reacting to a disclosure in the manner that amici describe.

For one thing, the theory of efficient markets has never required that markets be *perfectly* efficient. *See Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1130 (7th Cir. 1993) ("'Efficiency' is not an all-or-nothing phenomenon."); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 528 (7th Cir. 1985) (market efficiency is imperfect because "people cannot interpret information flawlessly"). In *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), where this Court adopted the "fraud on the market" theory of reliance, the Court simultaneously warned that it did "not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price." *Basic*, 485 U.S. at 248 n.28

So, for example, information that is publicly released but not widely publicized, or written in highly technical language, or whose significance is not immediately obvious,

may take a longer time to affect a stock's price. *See In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1116 (9th Cir. 1989); *Marksman Partners LP v. Chantal Pharmaceutical Corp.*, 927 F. Supp. 1297, 1307-08 (C.D. Cal. 1996). For this reason, it is not unusual to see fact patterns in which publicly available information has little effect on stock price, but after its significance is highlighted in a *Wall Street Journal* article, the stock price drops. *See, e.g., Oran v. Stafford*, 226 F.3d 275, 280-83 (3d Cir. 2000); *Control Data*, 933 F.3d at 618.

Trading patterns unrelated to the disclosure can affect immediate market reaction. During holidays, trading is typically lighter and market reactions unreliable. *See, e.g.*, Theopolis Waters and Curt Thacker, *Commodities Report: Lean-Hog Contracts Tumble As Supplies Top Expectations*, Wall Street Journal, Jan 2, 2003, at C12 (market reaction uncertain until traders return from holiday). Computerized trading strategies can influence market reaction in ways divorced from the actual content of the information disclosed. *See generally* Jerry W. Markham and Rita McCloy Stephanz, *The Stock Market Crash of 1987 – The United States Looks at New Recommendations*, 76 Geo. L.J. 1993, 2032 (1988).

The presence of such real-world inefficiencies – which *Basic* itself acknowledged – does not undermine *Basic*'s core holding that false information will affect a corporation's stock price. However, such inefficiencies do mean that not all pieces of information are received equally. On a motion to dismiss, when presumptions are drawn in favor of the plaintiff, it is perfectly appropriate to presume that false statements have inflated a stock's market price (subject to rebuttal with evidence at later stages of litigation, *see Basic*, 485 U.S. at 245-46). But that presumption does not, at the

pleading stage, require a court to assume that when the truth is disclosed, the market immediately reacts in perfect tandem to the original fraud.

This principle is demonstrated a line of case law developed in the wake of *Basic* known as the "truth on the market" doctrine. The doctrine posits that truthful information, like false information, will penetrate the market and offset any inflationary effect of the fraud. Although several circuits have accepted the legitimacy of the "truth on the market" rebuttal to "fraud on the market" allegations, *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 (2d Cir. 2000); *Asher v. Baxter Int'l Inc.*, 377 F.3d 727, 735 (7th Cir. 2004); *Apple Computer*, 886 F.2d at 1116, they stress that truthful information will not offset false information unless it has been "transmitted to the public with a degree of intensity and credibility sufficient to effectively counter-balance any misleading impression created by the insiders' one-sided representations." *Apple Computer*, 886 F.2d at 1116; *see Ganino*, 228 F.3d at 167 (same). Thus, these courts acknowledge that it cannot be immediately assumed that offsetting truthful information will be incorporated into stock prices with perfect efficiency. As the Second Circuit put it, "the laws of economics have not yet achieved the status of the law of gravity." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 270-71 (2d Cir. 1993).[11]

Even in an efficient market, other countervailing forces may influence the stock price and prevent a drop immediately

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11. The "lookback" provision of the PSLRA acts as a congressional acknowledgment that markets are not perfectly efficient. As discussed above, the provision is premised on the notion that markets may occasionally "overreact" to bad news and will take some time to settle into an appropriate equilibrium.

following an adverse disclosure. Unsurprisingly, companies do not like to see their stock prices drop and thus may time announcements of bad news to coincide with offsetting announcements of good news. *Cf. Am. W. Holding Corp.*, 320 F.3d at 935 (delay in market reaction due in part to defendant's efforts to assure analysts that there would be no effect on company). Or, unrelated conditions may influence the stock upward so as to offset any negative price effect. The economy generally, or the industry specifically, may be causing market *gains* such that a company's announcement of adverse information only has the effect of keeping the stock price stable. Under such circumstances, there is still a loss to investors in that the stock did not appreciate as it should have. *See Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831-32 (8th Cir. 2003) ("If a stock does not appreciate as it would have absent the fraudulent conduct, investors have suffered a harm.").

The stock price may also appear to remain stable because of the sheer number of shares issued. The more shares, the less each particular share will be affected by damaging news, although even a drop by a few pennies may represent the loss of significant amounts of market capitalization.

Finally, the market may already have accounted for the company's true financial condition at some earlier date. Even before the company admits, say, that earnings were overstated or that it has underreserved for bad debt, the truth may have manifested itself through some related financial crisis, through gradual market skepticism of reported results, through the counterbalancing release of truthful information over time, or – most insidiously – the corporation itself might deliberately deflate its stock price with false "bad" news in

order to prepare the market for news of the fraud. As this Court observed in *Basic*

> We note there may be a certain incongruity between the assumption that Basic shares are traded on a well-developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements. Proof of that sort is a matter for trial. . . .

485 U.S. at 249 n.29.

The more remote in time the original fraud, the more likely that the market price may have already corrected for the artificial inflation. *Cf. Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 n.3 (9th Cir. 1987) (noting that "the prolonged nature of the fraud may have introduced other market variables which affected the amount the market reacted to the disclosure."). Moreover, if the fraud is remote in time and the market perceives that the stale information is unlikely to have significant effects on company performance going forward, this too may leave stock prices unaffected, even if, at some earlier point, stock prices were inflated as a result of the fraud with accompanying losses to shareholders once equilibrium was restored. *See Control Data*, 933 F.2d at 620 n.8; *cf. Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 514 (7th Cir. 1989) ("Investors value securities because of beliefs about how firms will do tomorrow, not because of how they did yesterday.").

C. Loss Causation Need Not Be Pled With Particularity

Some amici contend that complaints must be dismissed unless they contain detailed allegations regarding the inflationary and deflationary effects of the false statements and the eventual disclosure of the truth. Such detailed pleading is not required by the PSLRA or the Federal Rules of Civil Procedure.

"Where, as here, the statute's language is plain, the sole function of the courts is to enforce it according to its terms." *United States v. Ron Pair Enters.*, 489 U.S. 235, 241 (1989) (quotations and citations omitted). The PSLRA requires only that plaintiffs "have the burden of proving," not pleading, loss causation. 15 U.S.C. § 78u-4(b)(4). This provision stands in marked contrast to other PSLRA provisions that specifically target contents of complaints. *Compare* 15 U.S.C. §§ 78u-4(b)(1), 78u-4(b)(2). It is also significant that paragraph (b)(3) of the PSLRA instructs courts to grant motions to dismiss "if *the requirements of paragraphs (1) and (2) are not met.*" 15 U.S.C. § 78u-4(b)(3)(A) (emphasis added). This provision does not mention paragraph (b)(4) dealing with loss causation. *Id.* The natural conclusion is that while failure to *prove* loss causation will defeat a claim, the PSLRA imposes no special pleading requirements with respect to loss causation beyond those ordinarily required by the Federal Rules of Civil Procedure. *See ConAgra*, 335 F.3d at 830 n.3.

Contrary to the assertion of the United States, Brief of United States at 15, loss causation need not be pled with particularity under Rule 9(b).[12] Rule 9(b) provides that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." The courts of appeals have uniformly interpreted the phrase "circumstances constituting fraud" to mean the time, place, and content of the alleged false representation, and the identity of the person making the false statement. These courts do not require special pleading of other

12. Even if Rule 9(b) did require pleading loss causation with particularity, some courts have held the PSLRA supercedes reliance on 9(b) in securities fraud cases. *See In re Navarre Corp. Securities Litigation*, 299 F.3d 735, 742 (8th Cir. 2002); *Lipton v. PathoGenesis Corp.*, 284 F.3d 1027, 1034 n.12 (9th Cir. 2002).

elements of the action. *See, e.g., Edwards v. Marin Park, Inc.*, 356 F.3d 1058, 1065-66 (9th Cir. 2004); *Yuhasz v. Brush Wellman, Inc.*, 341 F.3d 559, 563 (6th Cir. 2003); *United States ex rel. Willard v. Humana Health Plan of Texas Inc.*, 336 F.3d 375, 384 (5th Cir. 2003); *Schaller Tel. Co. v. Golden Sky Sys., Inc.*, 298 F.3d 736, 746 (8th Cir. 2002); *Bd. of Trs. v. Foodtown, Inc.*, 296 F.3d 164, 173 n.10 (3d Cir. 2002); *Caputo v. Pfizer, Inc.*, 267 F.3d 181, 191 (2d Cir. 2001); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1202 (11th Cir. 2001).

"Circumstances constituting fraud" are pled with particularity in order to give sufficient notice to defendants to respond to the charges, *see, e.g., Novak v. Kasaks*, 216 F.3d 300, 312 (2d Cir. 2000), and to deter the filing of frivolous fraud claims, *see Ackerman v. Northwestern Mut. Life Ins. Co.*, 172 F.3d 467, 469 (7th Cir. 1999). Neither of those purposes is served by requiring detailed pleading of loss causation in the securities context.

The "notice" intended to be imparted by Rule 9(b) particularity is notice of the type of fraud alleged, because "fraud" is generally thought to be an amorphous concept. As this Court stated:

> 'Fraud is infinite, and were a Court of Equity once to lay down rules, how far they would go, and no farther, in extending their relief against it, or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes which the fertility of man's invention would contrive.'

SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 n.41 (1963) (*quoting* Letter of Lord Hardwicke to Lord Kames, dated June 30, 1759). This sort of notice is not enhanced by the detailed pleading of loss causation; the PSLRA's requirement

that complaints "state with particularity all facts" that form the basis for plaintiffs' belief in the falsity of defendants' statements, 15 U.S.C. § 78u-4(b)(1), provides defendants with all the notice that they require.

Nor is heightened pleading of loss causation necessary to deter frivolous lawsuits, because the PSLRA's heightened pleading requirements ensure that cases will only proceed to discovery after plaintiffs have alleged facts that create a "strong inference" that the defendants acted with an intent to defraud. Not only is this requirement sufficient to weed the frivolous from the potentially meritorious, but any further requirements in this respect run the risk of burdening meritorious, rather than frivolous, claims.

It would not be helpful to a court or to the parties to require detailed pleading of loss causation. As is clear from the above discussion, complicated market forces will affect stock price movements at different times. The "truth" about a corporation's condition may slowly be disclosed to the market over a prolonged period, and deflation of the stock price may correspondingly be a slow process, affecting those who buy and sell during the Class Period differently from those who hold their stocks through the end of the Class Period. Fraud in one area of a corporation may affect other aspects of the corporation's public disclosures, and other market variables may interact with the fraud in ways that affect the amount of losses. *See Wool*, 818 F.2d at 1437 n.3. The disclosure of apparently unrelated business problems that appear to be "intervening events" influencing the stock price may turn out to be related to the fraud, or timed to impact market reaction. It is simply impossible for these kinds of factors to be estimated without access to discovery and

without the use of expert opinion. *See Emergent Capital*, 343 F.3d at 197 ("[I]f the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation will not have been established. But such is a matter of proof at trial and not to be decided on Rule 12(b)(6) motion to dismiss."). If plaintiffs were required to plead detailed loss causation theories in their complaints, courts would be required to assess their viability in the inevitable motion to dismiss – all without access to the tools and evidence necessary to make an informed decision.

Amici insist that a vigorous loss causation pleading requirement is necessary in order to avoid reliance on vague expert studies that may not properly quantify losses attributable to the fraud. To begin, many of these arguments confuse *loss causation* with damages; as the United States concedes, Brief of United States at 16 n.1, these are different concepts and involve different sorts of evidence. *Cf. Restatement (Second) of Torts* § 7 (1965) (distinguishing between "injury," which forms the basis for a lawsuit, and "harm," which constitutes actual damage); *see also Miller v. Asensio & Co.*, 364 F.3d 223, 229 (4th Cir. 2004) ("[A]lthough courts use 'damages' (as well as 'injury,' 'harm,' or 'loss') in discussing liability in 10b-5 cases, they employ that term to resolve a different question than the amount of recoverable damages."). Additionally, there is not so much as a hint that Congress was concerned with problems of *evidence* when it crafted the PSLRA, and amici offer no explanation for why this Court should presume that the loss causation element of a 10b-5 action was intended to replace Federal Rules of Evidence as a mechanism to ensure the reliability of proofs. It is also difficult to see how problems of proof will be remedied by moving the trial up to the pleadings stage and

requiring the court to resolve such issues *without* the benefit of evidence.[13]

The fallacy of requiring detailed loss causation pleading is made clear in *D.E.&J Ltd. P'ship v. Conaway*, 284 F. Supp. 2d 719 (E.D. Mich.), *appeal docketed*, Nos. 03-2334, 03-2417 (6th Cir. Oct. 3, 2003). In that action, the Kmart corporation suffered from a deteriorating financial condition which ultimately led it to file for bankruptcy. The plaintiffs alleged that Kmart had attempted to conceal its condition with false financial statements. The district court, however, concluded that plaintiffs had failed to allege loss causation, for two reasons. First, the district court made the same error involved in *Merrill Lynch*: it mistook an event that brought

13. Amicus Merrill Lynch describes what it terms the "speculative" proof offered in cases currently pending before the district courts regarding allegations that it engaged in fraudulent and manipulative IPO allocation practices and exerted undue influence on its research analysts for the benefit of its investment banking operations. Obviously, the reliability of the proofs offered in those actions is not something that this Court is called upon to decide. Additionally, the loss causation questions in those cases differ in significant ways from the allegations in the current matter because plaintiffs in those actions allege intentional market manipulation through conduct, rather than through false statements alone. *See* 17 C.F.R. § 240.10b-5(a),(c). What is clear, however, is that the State of New York considered the conduct at issue in the analyst conflict actions to be sufficiently damaging to investors that it fined Merrill $100 million and required it to make sweeping structural reforms. See Press Release, New York Attorney General (May 21, 2002) ("Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices"), *available at* http://www.oag.state.ny.us/press/2002/may/may21a_02.html. Moreover, many of Merrill Lynch's arguments appear to be directed more toward transaction causation, *i.e.*, whether the conduct had any effect on stock price in the first instance, rather than toward loss causation, which is the issue before the Court.

the truth to light for an intervening cause, deciding that certain drops in Kmart's stock price could be attributed to the "intervening cause" of the bankruptcy itself. *See id.* at 749 n.26. The district court's second error was to hold that the decline in Kmart's stock price prior to the bankruptcy could not be attributed to the company's deteriorating financial position, and instead was due to the events of September 11 and the war in Afghanistan. *See id.* at 749 n.26. The district court came to this conclusion solely by performing its own comparison of Kmart's stock price to the market generally, taking judicial notice of facts about market performance that had not been included in the complaint. But it should be obvious that such a crude comparison might easily miss other relevant factors, such as the performance of other retailers or Kmart's own performance history. These sorts of issues cannot be resolved at the pleadings stage.

IV. The Complaint Meets Rule 8 Pleading Standards for Loss Causation

Because nothing in the PSLRA or the Federal Rules of Civil Procedure requires that allegations of loss causation be plead with any particularity, it is sufficient if this aspect of the complaint meets the requirements of Rule 8, namely, that it contain a "short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a)(2). The complaint need not "set out in detail the facts upon which [the plaintiff] bases his claim" so long as the defendant is given "fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Conley v. Gibson*, 355 U.S. 41, 47 (1957). As this Court held in *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506 (2002), "This simplified notice pleading standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims." *Id.* at 512.

Here, the complaint alleges that Class Members were harmed as a result of the false statements of the defendants, while providing exceedingly detailed allegations regarding the nature of the fraud itself. The complaint thus satisfies applicable pleading standards and the Ninth Circuit's decision should be affirmed. *See EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 885 (3d Cir. 2000) (loss causation pled by asserting that defendant's false statements caused financial loss to plaintiff).

CONCLUSION

In sum, nothing in the PSLRA suggests that the loss causation requirement was intended to heighten plaintiffs' pleading burden or to serve a "gatekeeper" function to permit courts to dismiss more easily securities fraud cases. Rather, other provisions of the PSLRA are intended to facilitate early dismissals, and these provisions are clearly marked. The complaint in this action is sufficient to meet notice pleading standards for the element of loss causation, and the Ninth Circuit's decision should be affirmed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC. ET AL.,

Petitioners,

—v.—

MICHAEL BROUDO ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF CITY OF NEW YORK PENSION FUNDS, THE CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM, LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION AND ALAN G. HEVESI, COMPTROLLER OF THE STATE OF NEW YORK, AS TRUSTEE OF THE NEW YORK STATE COMMON RETIREMENT FUND AND AS ADMINISTRATIVE HEAD OF THE NEW YORK STATE AND LOCAL RETIREMENT SYSTEMS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF THE *AMICI CURIAE*

This *amicus* brief is filed on behalf of the pension funds of the City of New York ("NYC Pension Funds"), the California Public Employees' Retirement System ("CalPERS"), the California State Teachers' Retirement System ("CalSTRS"), Los Angeles County Employees Retirement Association ("LACERA") and Alan G. Hevesi, Comptroller of the State of New York, as Trustee of the New York State Common Retirement Fund and as Administrative Head of the New York State and Local Retirement Systems ("NYSCRF") (collectively, the "Public Pension Funds" or "Funds"). The Public Pension Funds are comprised of four of the five largest public pension systems in the United States.

The NYC Pension Funds comprise the actuarial pension systems of New York City and are among the largest public pension systems in the United States.[1] The NYC Pension Funds include the New York City Employees' Retirement System, the Police Pension Fund, the Fire Department Pension Fund, the Teachers' Retirement System, the Board of Education Retirement System, and five variable supplement funds.[2] As of June 30, 2003, the

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[1] Pursuant to Supreme Court Rule 37.4, *amicus* the NYC Pension Funds states that they are instrumentalities of the City of New York, and this brief is being presented by Leonard J. Koerner, Chief Assistant Corporation Counsel, Corporation Counsel of the City of New York. In addition, *amici* state that no counsel for any party authored this brief in whole or part, and no person or entity other than the *amici* made a monetary contribution to the preparation or submission of the brief. Pursuant to Rule 37.3, *amici* state that petitioners and respondents have consented to the filing of this brief. Petitioners' and respondents' letters of consent have been filed with the Clerk of the Court.

[2] The variable supplement funds are: New York City Police Superior Officers' Variable Supplements Fund, New York City Police Officers' Variable Supplements Fund, New York City Fire Officers'

date of the most recent actuarial valuations for these Funds, the NYC Pension Funds had approximately 253,000 retired members, 340,000 active members, and aggregate assets of $73.971 billion.

CalPERS, the largest public pension fund in the United States, manages pension and health benefits for more than 1.4 million California public employees, retirees, and their families. CalPERS' membership is divided approximately in thirds among current and retired employees of the state, schools, and participating public agencies. As of September 30, 2004, CalPERS provided benefits for 1,014,360 active and inactive members and 413,272 retirees. As of August 31, 2004, CalPERS has $165.3 billion in total investments, of which nearly $110 billion is in equities.

CalSTRS is the largest teachers' retirement system in the United States. CalSTRS' primary responsibility is to provide retirement related benefits and services to teachers in public schools from kindergarten through community college. As of June 30, 2003, CalSTRS had a total membership of approximately 734,963 (553,095 active/inactive and 181,868 retired/benefit recipients) and, as of June 30, 2004, had total assets of $116.1 billion.

LACERA is the largest county retirement system in the United States. LACERA provides retirement, disability, and death benefits to eligible Los Angeles County employees and their beneficiaries. As of June 30, 2004, LACERA had a total membership of approximately 140,000 and total assets of nearly $30 billion.

NYSCRF is the second largest public pension fund in the United States. NYSCRF provides pension, death and

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Variable Supplements Fund, New York City Firefighters' Variable Supplements Fund, and New York City Teachers' Retirement System Variable Annuity A and B Programs.

disability benefits for New York state and local government employees and employees of certain other participating employers. As of March 31, 2004, NYSCRF had over 970,000 members, beneficiaries and retirees, and total net assets of approximately $120.8 billion.

The Public Pension Funds' overriding responsibility is to provide for the retirement and long-term security of their more than 3.8 million active and retired members. To satisfy that responsibility, the Public Pension Funds invest in a wide variety of stocks, bonds and other assets, through a variety of advisors, in order to maintain the long-term growth and security of their members' assets. As major investors with a long-term investment outlook, the Public Pension Funds are vitally concerned with the proper and efficient functioning of U.S. capital markets, and are particularly concerned that investors not be harmed by the improper and/or illegal conduct of issuers and sellers of publicly traded securities.

Over the last five years, the Public Pension Funds have become increasingly concerned that the pressure for short-term profit maximization at a number of enormous and well-respected U.S. (and foreign) corporations has created an environment in which management, their advisors (including outside advisors such as accountants and lawyers), and others involved in the purchase and sale of their securities (stock brokerage firms, investment banking firms, *etc.*) are willing to engage in unethical, illegal and improper behavior to manipulate stock prices for their personal or institutional benefit. The scandals at Enron, WorldCom, Global Crossing, Tyco, Bristol-Myers, Xerox and others are now synonymous with the culture of greed that has tarnished all U.S. corporations and caused hundreds of billions, if not trillions of dollars in losses to innocent investors. The Public Pension Funds have lost billions of dollars in invest-

ments where the prices were inflated through accounting fraud, market manipulation and other means.

The Public Pension Funds recognize that the oversight of regulators such as the U.S. Securities and Exchange Commission and the New York Attorney General's Office is an important means of ensuring a level playing field for all investors. The Funds strongly believe, however, that the ability of investors to seek to redress corporate wrongdoing through class and individual actions brought under the Securities Act of 1933 ("1933 Act"), 15 U.S.C. § 77a *et seq.* and the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78a *et seq.*, is an important mechanism to deter improper conduct and to recoup losses that investors have suffered as a result of fraud and other misconduct. Thus, the Public Pension Funds have acted as lead plaintiffs in several significant cases, including *In re Cendant Corporation Securities Litigation*, (D.N.J.) (NYC Pension Funds, NYSCRF and CalPERS were co-lead plaintiffs), where the $3.2 billion settlement remains the largest recovery in the history of securities litigation. In addition, NYSCRF as lead plaintiff in the *In re WorldCom, Inc. Securities Litigation* (S.D.N.Y.) has secured District Court approval of the second largest settlement in history, nearly $2.6 billion from Citigroup defendants, Citigroup, Inc., Citigroup Global Markets, Inc. (formerly known as Salomon Smith Barney, Inc.), Salomon Brothers International Limited, and former securities analyst Jack Grubman. LACERA has served as lead plaintiff in the *Enterasys Networks, Inc. Securities Litigation* (D.N.H), and the *King Pharmaceuticals Securities Litigation* (E.D.TN), and CalSTRS is serving as lead plaintiff in *In re Homestore Securities Litigation* (C.D. Cal.). Certain of the Public Pension Funds also have brought individual actions against Bristol-Myers Squibb, Inc., Qwest Communications, Inc., and others.

A key element of the legal regime governing the initiation, prosecution and resolution of claims under Section 10(b) of the 1934 Act, and Rule 10b-5 promulgated thereunder, is the issue of loss causation. While the Public Pension Funds recognize that the federal securities laws are not a form of "insurance" to protect investors against market-based declines in the price of securities and that companies should not be liable for declines in their stock prices that do not result from their fraudulent conduct, as investors who have been materially harmed by entities that have resorted to fraudulent and improper conduct, the Funds are vitally concerned that the legal regime governing securities fraud litigation allows investors who have been harmed to recover from those entities that have engaged in fraud. At the same time, as significant investors in thousands of corporations and business entities that never have been touched with so much as a taint of fraud, the Public Pension Funds have a strong interest in ensuring that the rules governing securities litigation do not unfairly harm companies that have not engaged in wrong-doing. Because a failure by a plaintiff to plead and ultimately prove loss causation will impair that plaintiff's ability to recover for fraudulent conduct, the Public Pension Funds are submitting this brief as *amici curiae* to assist this Court in developing rules that adequately protect honest companies and their investors, while permitting valid claims against those companies that have engaged in fraudulent conduct.

SUMMARY OF ARGUMENT

The Public Pension Funds support the Respondent and believe that the decision of the Ninth Circuit in *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir. 2003), *cert. granted, Dura Pharmaceuticals, Inc. v. Broudo*,

124 S. Ct. 2904 (U.S. June 28, 2004) (No. 03-932), which does nothing more than follow a notice pleading standard for loss causation under Rule 8 of the Federal Rules, should be affirmed. At the pleading stage, under the liberal pleading requirements of Rule 8 of the Federal Rules of Civil Procedure, a plaintiff should be required merely to allege a "short and plain statement" that (i) the stock price was inflated by fraud and (ii) the inflation, at least in part, has been removed. At the pleading stage, a plaintiff should not be required to demonstrate the negative impact on the share price of each piece of information that may have revealed some aspect of the defendants' fraud. A plaintiff ultimately should be required to demonstrate that he or she overpaid for a security as a result of the dissemination of fraudulent information about the company, and that the price of the stock no longer is inflated due to fraud. There should be no requirement, however, that a defendant have made an explicit disclosure that fraud has occurred nor should there be any requirement that there be a stock price drop immediately following a specific admission of fraud in order to state a claim as a matter of law.

The issue of loss causation, as it has evolved over the last thirty years, is codified in the Private Securities Law Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4, and is essentially a requirement that a plaintiff establish "that the act or omission of the defendant alleged to violate [the 1934 Act] caused the loss for which the plaintiff seeks to recover damages." *Id.* at § 78u-4(b)(4). In most securities fraud cases, the "loss" at issue is related to a decline in the value of a stock or bond caused by the disclosure of prior fraudulent statements by the issuer of the security, the issuer's agent (usually an accountant) or a third party that has an interest in manipulating the price of the security. Thus, the proper goal of any test

for loss causation is to determine the legal responsibility for changes in the price of stocks, bonds and/or other securities that were impacted by materially false statements.

The entire discipline of corporate finance, a mainstay of U.S. business schools over the last two to three decades, has, as one of its primary goals, the development of models to determine the true economic value of business entities. The principles of corporate finance, while greatly utilized in the business world to determine the value of corporations and securities that reflect ownership in corporations, as well the basis for changes in valuations, are much less frequently used by courts in making legal determinations regarding changes in the value of securities. Because a key issue in lawsuits brought under the federal securities laws is the cause of the decline in the value of securities, *i.e.*, loss causation, an issue that is subject to these well-understood principles of corporate finance, the Public Pension Funds respectfully urge that any legal determination as to what caused the decline in the value of the security should generally be premised upon such corporate finance principles.

The present case represents this Court's first opportunity to address directly the legal principles that will govern the pleading and proof of loss causation in securities fraud litigation. In conducting its analysis, the Court should be fully aware of, and should reach a decision consistent with, principles of corporate finance, which generally equate the value of a corporation with investors' expectations of the "cash flows" that they ultimately will receive from that corporation.[3] Under sound

[3] A method other than cash flow expectations may need to be used to value corporations in some circumstances. *See M.G. Bancorporation, Inc. v. LeBeau*, 737 A.2d 513, 524 (Del. 1999) ("by recognizing the discounted cash flow model as one proper valuation technique, the

principles of corporate finance, where expectations of future cash flow have been artificially inflated because of fraud, the resulting stock price also is artificially inflated by fraud. Thus, as explained in detail below, the Public Pension Funds propose that this Court adopt a test for loss causation, based on fundamental principles of corporate finance, that poses the following questions: (1) did a defendant make a materially misleading statement to the investing public that inflated the stock price of a company, and (2) as the result of disclosures of information by the company or others, is the stock price no longer inflated because the fraud is no longer propping-up the price? Where these questions are answered in the affirmative, loss causation is established.

Any requirement, such as that implicit in Petitioner's opening brief (Pet'r Br. at 21-22, 37), or as explicitly set forth in the briefs of certain *amicus curiae* (Brief of Chamber of Commerce of the United States as *Amicus Curiae* in Support of Petitioners ("CC Br.") at 13-14), that there must be an explicit disclosure of fraud followed by a stock price drop, would be inconsistent with the law and basic corporate finance principles, and would allow many frauds to fall outside the ambit of the securities laws.

Finally, while a plaintiff ultimately should be required, with the benefit of discovery and expert analysis, to establish that the price of a stock was no longer inflated due to fraud, no such strict linkage should be required at the pleading stage. Plaintiffs are required to plead fraud with particularity and to plead facts supporting a strong inference of defendants' scienter. Thus, any case that survives a motion to dismiss, even using the Ninth Circuit standard on loss causation for pleading purposes (or a similar standard), will have adequately pled the existence of fraudulent statements that inflated the price of the security at issue and strong support that such statements were knowingly or recklessly made. Where these facts can be pled, it is not unduly onerous on defendants if Plaintiffs are permitted to prosecute their action.

Court of Chancery was not required to use that methodology. . . ."). However, using corporate finance principles will allow this Court to establish an appropriate standard for loss causation.

On the other hand, establishing a strict loss causation requirement at the pleading stage is inconsistent with federal pleading standards and will place unfair burdens on securities plaintiffs. Any requirement that securities plaintiffs be required to plead, other than in general terms, a linkage between changes in the price of a stock and specific disclosures could require a detailed expert opinion demonstrating that revelation of the fraud had an impact on the price of the securities at issue. Requiring such an expert report at the pleading stage would effectively preclude meritorious actions because of the enormous expense of such reports (*see infra* Section I.A) and the need (in many cases) for some discovery to produce a rigorous report. Thus, the Court should affirm the decision of the Ninth Circuit for pleading purposes.

ARGUMENT

I. THE COURT SHOULD ADOPT A FLEXIBLE STANDARD FOR PROVING LOSS CAUSATION AND SHOULD NOT ADOPT A STANDARD THAT WOULD REQUIRE PLAINTIFFS TO SHOW A DECLINE IN THE PRICE OF A SECURITY AFTER THE EXPLICIT DISCLOSURE THAT FRAUD HAS OCCURRED

The Court below in *Broudo v. Dura Pharmaceuticals, Inc.*, addressed a situation in which a defendant revealed truthful information that corrected earlier, allegedly

fraudulent information, but the stock drop complained of had occurred ten months prior to the truthful disclosure. It held that:

> "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, *because the injury occurs at the time of the transaction . . . . [L]oss causation does not require pleading a stock price drop following a corrective disclosure or otherwise.* It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of cause."

339 F.3d at 938. In opposing the loss causation standard adopted by the Ninth Circuit, Petitioner suggests (and certain *amici* specifically argue) that loss causation should only be established where there is a price decline following the explicit disclosure of fraud. (Pet'r Br. at 21-22, 37; CC Br. at 13-14) Certain courts and commentators have propounded such a rule and concluded that a stock drop following the explicit disclosure of fraudulent activity is essential to establish loss causation and, hence, is a *sine qua non* for a plaintiff to prevail on the merits and ultimately recover damages. *See, e.g., Arduini/Messina P'ship v. Nat'l Med. Fin. Servs. Corp.*, 74 F. Supp. 2d 352, 361–62 (S.D.N.Y. 1999); *Anderson v. First Sec. Corp.*, 249 F. Supp. 2d 1256, 1268 (D. Utah 2002); *In re Sprint Corp. Sec. Litig.*, 232 F. Supp. 2d 1193, 1228 (D. Kan. 2002).[4]

An inflexible rule such as that proposed by Petitioners, some *amici* and certain commentators has the potential to create serious problems since it would effectively eliminate a large number of meritorious actions at the

[4] *See also* Brian E. Pastuszenski et al., *Beyond Materiality and Scienter: Strategies For Successfully Defending Securities Class Actions By Attacking Plaintiffs' Loss Causation and Damages Theories*, ALI-ABA Securities Litigation Planning and Strategies 572–73 (2001).

pleading stage in order to address a very small subset of securities cases. Three examples will illustrate the problem. The classic securities fraud case, where the stock price collapses upon disclosure of fraud, typically does not present a difficult loss causation issue. Assume that the stock of Company A (with 100 million shares) is priced at $10 per share at the beginning of a period and, thereafter, Company A makes false statements that its revenues were $1 billion last year and its profits were $250 million. Based upon those favorable reports, investors believe the Company will earn $300 million or $3 per share going forward. As a result, the price of the stock increases to $30 per share. Six months later, the Company admits that its $1 billion in revenue and $250 million in profits were false because of the booking of fictitious sales and that the correct numbers were $750 million in revenues and a $200 million loss. Investors immediately understand that the Company will not be earning $300 million ($3 per share) going forward. The stock price immediately falls to $10 per share as investors determine that the Company will probably just break-even over the next year. In this case, under any theory, there clearly is loss causation since the announcement of the true information causes an immediate and substantial decline in the cash flow expectations and share price.

The more difficult situation however, and one that is common in financial fraud securities cases, is where Company A does not explicitly label corrective information as related to a fraud. Assume, as above, that Company A releases false information that its revenues were $1 billion and its profits were $250 million. As a result, investors believe the Company will earn $300 million going forward, or $3 per share. However, the actual undisclosed numbers were $750 million in revenues and a $200 million loss. Over the next six months the stock price increases to $30 per share. At the end of

the six months, the Company realizes it has a problem and will not be able to keep booking the fictitious sales. Rather than disclose the truth about its past practices, over the next few months, the Company gradually discloses that it will only break-even over the next year. The stock price declines to $10 based upon those deflated expectations. Investors do not know that the deflation in the expectations is the result of a fraud. Only after the price has declined to $10 does the Company admit that its older financial information ($1 billion in revenue and $250 million in profits) was false, that its true information for that year was $750 million in revenue and a $200 million loss, and that its more recent information is accurate. After this announcement, however, the share price does not decline further because the market has already incorporated the decline in expectations resulting from the cessation of the fraud in the Company's stock price.

Under such circumstances, the Petitioner would take the position, as would some of the *amicus* briefs, decisions and commentators referenced above, that there is no loss causation because the share price did not decline after the disclosure of the existence of the fraud. Yet investors in this scenario purchased a stock at an inflated price due to fraud and lost money when the stock price declined because truthful information was revealed about the company's actual performance and the fraud no longer propped-up the price. The only difference between the second scenario and the first scenario is the manner in which the fraud is disclosed. In the second scenario the company manipulated the disclosure, cleverly revealing the truth without labeling it fraud.

The third scenario, which essentially is the one upon which the Petitioner focuses, is where Company A releases the same false information described above ($1 billion in

revenue, $250 million in profits) causing investors to believe there will be $300 million in earnings and thus the price increases to $30 per share. Thereafter, as the result of some event wholly unrelated to the fraud (market-shift, earthquake, fire, *etc.*), Company A becomes essentially worthless. Thereafter, the fraud is disclosed and a suit is brought for securities fraud. In such a case, the plaintiff will be unable to prove that the fraud caused the loss. Therefore, loss causation is absent.

The Public Pension Funds believe that an appropriate standard of loss causation is one that does not eliminate the meritorious cases that fall under example two above, merely to ensure that the cases that conform to example three do not result in the imposition of damages. Thus, while the Public Pension Funds agree that, at trial, loss causation requires some showing that the price of a stock no longer was inflated as the result of the disclosure of information correcting earlier fraudulent information, the Court should not adopt a standard that requires a plaintiff to prove the existence of a stock drop following the explicit disclosure of fraud. Such a standard would be inconsistent with the origins and development of the loss causation doctrine and contrary to applicable principles of corporate finance. Instead, this court should adopt a flexible standard under which the issues are whether the stock price was inflated by fraud and whether that inflation no longer is present because the fraud no longer is impacting the price. If a plaintiff can establish the existence of these two conditions, loss causation should be established.[5]

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[5] *See* Jay Eisenhofer, Geoffrey Jarvis & James Banko, *Securities Fraud, Stock Price Valuation And Loss Causation: Toward A Corporate Finance-Based Theory Of Loss Causation*, 59 Bus. Law. 1419, 1441-45 (2004) (setting forth in detail a theory of loss causation based upon corporate finance principles).

A. Proof Of Loss Causation Is Inherent In Any Proof Of Damages

Proving loss causation often is inextricably linked to the analysis of damages, since both inquiries seek to determine the links between a defendant's fraudulent conduct and the consequent losses suffered by plaintiffs from a decline in the price of a security. Many early securities cases simply fixed the damages as the difference between the price paid for the securities and the value of the securities determined as of the time of the discovery of the fraud. *See Esplin v. Hirschi*, 402 F.2d 94, 104–05 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969) (court held the defrauded buyer is entitled to recover the difference between the price paid for the securities and the value of the securities determined as of the time of the discovery of the fraud); *Harris v. American Inv. Co.*, 523 F.2d 220, 226–27 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976) (appropriate date for ascertaining damages sustained to stockholder as result of violation of securities laws prohibiting publishing of false and misleading statements and filing of false and misleading information was the date of public discovery of fraud). This methodology was simple enough, but met with opposition from defendants and commentators because it ignored factors impacting stock price, such as overall economic and industry factors, that were unrelated to any possible fraud. *See, e.g.*, Barry Reder, *Measuring Buyers' Damages in 10b-5 Cases*, 31 Bus. Law. 1839, 1846–50 (1976).

In 1976, Judge Sneed of the United States Court of Appeals for the Ninth Circuit, in a sconcurring opinion in *Green v. Occidental Petroleum Corp.* set forth a theory for measuring damages that proved to be a milestone. Judge Sneed postulated that in a securities fraud class action, the best way to measure the loss proxi-

mately caused by the misrepresentation of a defendant is to create a chart containing a "price line" and a "value line." 541 F.2d 1335, 1341, 1344 (9th Cir. 1976) (Sneed, J. concurring). Pursuant to Judge Sneed's method, damages are calculated by subtracting the true value of the stock on the date of purchase from the price actually paid, with the spread between the price and value lines varying over time. *See* Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. Rev. 883, 887 fig. 1 (1990).

As courts began to adopt Judge Sneed's "value line" concept, an issue arose as to the best methodology for determining a stock's "true value," *i.e.*, value absent the fraud. A methodology that began gaining some measure of acceptance was the use of an "event study" to determine true value. *See, e.g., Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 (9th Cir. 1987) (recognizing the significance of fraud-related and non-fraud related influences on the stock's price behavior and stating "the increment of artificial inflation caused by misrepresentations may fluctuate 'as a result of market forces operating on the misrepresentations.' "); *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993) (requiring use of an event study or similar analysis to more accurately isolate the influences of information specific to the Company which defendants allegedly distorted).

An event study is a statistical regression analysis that examines the effect of an event on a dependent variable, such as a corporation's stock price. *RMED Int'l, Inc. v. Sloan's Supermarkets, Inc.*, No. 94-5587, 2000 WL 310352, at *6 (S.D.N.Y. Mar. 24, 2000) (citing Jon Koslow, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 Fordham L. Rev. 811, 822 & n.50 (1991)). This approach assumes that the price and value of the security

move together except during days when disclosures of company-specific information influence the price of the stock. The analyst then looks at the days when the stock moves differently than would be anticipated based upon market and industry factors—so-called days of "abnormal returns." The analyst then determines whether those abnormal returns are due to fraud or non-fraud related factors. *See* Cornell & Morgan, 37 UCLA L. Rev. at 899–900. This effectively is a determination of loss causation since it establishes the link between the fraud and the loss.

Over time, the majority of courts have recognized the utility of the event study methodology in the securities context and have begun to require experts to include event studies with their damages reports in order "to distinguish between the fraud-related and non-fraud related influences on the stock's price behavior." *Oracle*, 829 F. Supp. at 1181. Courts have held that the event study method is "an accepted method for the evaluation of materiality damages to a class of stockholders in a defendant corporation." *In re Gaming Lottery Sec. Litig.*, 96-5567, 2000 WL 193125, at *1 (S.D.N.Y. Feb. 16, 2000) (citing Eugene Fama et al., *The Adjustment of Stock Prices to New Information*, 10 Int'l Econ. Rev. 1 (1969)); David Tabak & Frederick Dunbar, *Materiality and Magnitude: Event Studies in the Courtroom*, NERA Working Paper No. 34 (April 1999). Indeed, a number of courts have rejected or refused to admit into evidence damages reports or testimony by damages experts in securities cases that fail to include event studies or some similar analysis.[6] *See In re Northern Telecom Sec. Litig.*,

[6] A method other than an event study may be used to determine damages in a particular case. *U.S. v. Brown*, 2004 WL 2242513 (M.D.Pa. Aug 17, 2004) (applying methodology other than event study in determining loss).

116 F. Supp. 2d 446, 460, 468 (S.D.N.Y. 2000) (court granted defendants' motion for summary judgment where the defendants' expert had conducted an event study concluding that none of the allegedly fraudulent statements resulted in inflation of defendant's stock price and plaintiffs' expert did not conduct such a study); *Oracle Sec. Litig.*, 829 F. Supp. at 1181 (court found that the "[u]se of an event study or similar analysis is necessary more accurately to isolate the influences of information specific to Oracle. . ."). *See also In re Executive Telecard, Ltd. Sec. Litig.*, 979 F. Supp. 1021 (S.D.N.Y. 1997) (requiring an event study in a 10b-5 damages case and setting forth standards for such a study).

As a result of cases such as *Executive Telecard*, defendants have created an environment in which plaintiffs' damages analyses are required, in most cases, to comply with basic principles of corporate finance and include as damages only those factors that are related to the fraud. *See, e.g., In re WorldCom, Inc. Sec. Litig.*, No. 02-3288, 2003 WL 22420467, at *28 n.42 (S.D.N.Y. Oct. 24, 2003). Thus, an event study, a complex analysis often comprising thousands of pages of analysis prepared by an expert, is used to exclude factors from the overall economy (such as an overall stock market price decline), factors impacting the relevant industry, and factors related to the specific company that are not fraud related. Because of the detailed nature of these analyses, they require that the expert have access to substantial information regarding the fraud (often from discovery), take many months to prepare, and frequently cost many hundreds of thousands of dollars. Accordingly, as explained below, the Court, in determining the appropriate pleading standard (as opposed to ultimate requirements of proof at trial), should not establish a pleading standard that would effectively require plaintiffs to con-

duct event studies prior to the initiation of litigation. *See infra* Section II.

B. A Flexible Loss Causation Standard Is Consistent With Principles Of Corporate Finance

Under well-accepted theories of corporate value, a stock will be worth to investors what they ultimately can obtain from it—dividends or an increase in value through retained earnings. Richard Brealey & Stewart Myers, *Capital Investment and Valuation* 77 (McGraw Hill 2003). The best measure of what value a company ultimately will provide to investors is the discounted value of future cash flows, *i.e.*, discounted value of the cash that comes in less the cash that goes out over time. Thus, corporate finance theory holds that the stock price of a company reflects the market's estimation of the company's future cash flows into infinity, discounted to reflect the fact that money received in the future is less valuable then money received today. Such "discounting" is carried out through a "rate" that is equivalent to the company's cost of capital. *Id.* ("The value of a stock is equal to the stream of cash payments discounted at the rate of return that investors expect to receive on comparable securities").[7] This approach to valuation is broadly agreed upon by financial economists and is the

[7] *See also* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 Mich. L. Rev. 613, 616 n.11 (1988) ("Efficient market prices which reflect all available information relevant to the value of the stock are thought to measure rationally the 'worth' of stocks as financial instruments in terms of the present value of their expected future earnings, discounted for nondiversifiable risk."); Burton Malkiel, *Is the Stock Market Efficient?* 243 Science 1313, 1316 (1989) (describing the standard "rational" model of share pricing as one of determining the present discounted value of the future stream of dividends).

basis for substantial portions of modern corporate finance theory. *Id.*

Discounted cash flow ("DCF") analysis is typically used to determine the value of a company by calculating the present value of its future cash flows. The DCF analysis is premised on the assumption that the value of all of a corporation's assets is equal to the present value of the expected cash flow from those assets while they are held by the corporation. *Id.* at 52-54 ("the discounted-cash-flow (DCF) formula for the present value of a stock is just the same as it is for the present value of any other asset. We just discount the cash flows by the return in the capital market on securities of comparable risk."); *Neal v. Alabama By-Products Corp.*, No. 8282, 1990 WL 109243, at * 7 (Del. Ch. Aug. 1, 1990), *aff'd*, 588 A.2d 255 (Del. 1991) (noting that DCF analysis is considered by valuation experts to be a "preeminent valuation methodology") (citing Shannon Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (2d ed. 1989)).

The basic principle outlined above—that stock prices are a reflection of future cash flows—has received judicial acceptance by numerous courts in valuation and bankruptcy settings. *See Onti, Inc. v. Integra Bank*, 751 A.2d 904, 916 (Del. Ch. 1999) (in action for declaratory judgment on fairness of cash-out merger court stated "this Court has frequently employed the discounted cash flow as at least one method of valuation"); *Neal*, 1990 WL 109243, at * 7 (noting that DCF analysis is considered by valuation experts to be "preeminent valuation methodology"); *see also In re Valley-Vulcan Mold Co.*, No. 99-4129, 2001 WL 224066 (6th Cir. Feb. 26, 2001) (noting, with approval, that expert's "valuations were based on discounted cash-flow valuation, a well-recognized methodology for determining a business's going

concern values."); *In the Matter of Genesis Health Ventures, Inc.*, 266 B.R. 591, 613 (Bankr. D. Del. 2001) (noting the use of the discounted cash flow method as one method to support value of an enterprise).

Those principles have not, however, been widely employed in securities litigation, even though this information is relevant to the company's stock price as an indicator of the company's *future* cash flows. This is a mistake since these concepts have great relevance in that area. When a company publicly discloses its *present* or *past* financial performance, this information is relevant to the company's stock price as an indicator of the company's *future* cash flows.[8] Thus, looking at cash flows and at the information, whether correct or incorrect, that

[8] William Beaver, *Financial Reporting: An Accounting Revolution* 69 (Prentice-Hall 3d ed. 1998) ("A conceptual relationship can be established between accounting earnings and the price of common stock by introducing three critical links: (1) a link between security price and future dividends, (2) a link between future dividends and future earnings, and (3) a link between future earnings and current earnings"); Tom Copeland, Tim Koller & Jack Murrin, *Valuation: Measuring and Managing the Value of Companies* 154 (John Wiley & Sons 3d ed. 2000) ("[t]he first step in valuing a business is analyzing its historical performance. A sound understanding of the company's past performance provides an essential perspective for developing and evaluating forecasts of future performance"); George Foster, *Financial Statement Analysis* 220-24 (Prentice-Hall 2d ed. 1986) ("[t]he accounting literature contains many statements about what information is (or should be) impounded into security prices . . . . *A common assumption is that there is a mechanistic relation between reported accounting earnings and stock prices*") (emphasis in original); *see also* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1 (1982) (discussing use of current and historical data in determining cash flows for valuation); Jonathan Fuerbringer, *Yesterday's Earnings Don't Move Stocks. Tomorrow's Do*, N.Y. Times, Aug. 8, 2004, at 7 (citing analysis by Birinyi Associates demonstrating that expected future earnings, not past earnings, are the driver of stock prices).

impacts such flows, can be of substantial value to courts attempting to ascertain whether particular information provided to the public by defendants has actually impacted the price of a stock at issue in a particular case.

C. An Appropriate Standard for Pleading and Proving Loss Causation Should be Based Upon Sound Principles of Corporate Finance

From the origins of the doctrine, courts have grappled with the appropriate test for determining whether a specific set of facts establishes loss causation. Courts want a standard that requires the defendant's fraud to have caused the plaintiff's loss, but are struggling in those increasingly frequent cases where there is not a disclosure of fraudulent conduct followed immediately by a material decline in the price of the company's stock.

As shown above, some courts have effectively refused to consider the issue at all, finding that there can be no loss causation if a stock decline does not immediately follow a disclosure of fraud. *See, e.g., In re Ikon Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680, 687 (E.D. Pa. 2001). This makes no sense because there are clear cases of fraud where the stock declined substantially prior to the formal announcement of the fraud and thus there was little room for further decline after the fraud was announced. *See, e.g., Danis v. USN Communications, Inc.*, 73 F. Supp. 2d 923 (N.D. Ill. 1999); *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657 (5th Cir. 2004).[9]

[9] It is not surprising that the stock price will decline prior to an explicit admission that fraud has occurred since most corporations are loath to admit that they have committed fraud and are strongly motivated to manipulate their disclosures to make it appear as if no fraud has occurred, even where fraud has taken place.

Other courts require that the plaintiff establish a linkage between the defendants' fraudulent statements and the decline in the value of defendants' stock, but decline to specify the nature of such a "linkage." *See Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983); *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir. 1990), *cert. denied*, 496 U.S. 906 (1990); *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441 (11th Cir. 1997). A third group of courts (many in the Second Circuit) has tried to impose the "foreseeability" test used for proximate cause in tort cases, (*see Emergent Capital Investment Management, LLC, v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003)), but that test has effectively allowed courts to reach contrary results on equivalent facts. *Compare In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003), *with Burstyn v. Worldwide Xceed Group, Inc.*, No. 01 Civ. 1125, 2002 WL 31191741 (S.D.N.Y. Sept. 30, 2002).

Finally, some courts have only required that a plaintiff, in order to establish loss causation, demonstrate that the purchase price of a stock was inflated due to fraud, and have not imposed any requirement that the ultimate decline in the price be strictly linked to the fraud. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 934-35 (9th Cir. 2003); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824 (8th Cir. 2003), *reh'g denied*, 2003 U.S. App. LEXIS 17920 (8th Cir. Aug. 27, 2003); *Danis*, 73 F. Supp. 2d at 923.

In order to make loss causation a predictable and logically sound part of federal securities jurisprudence, the Public Pension Funds propose that the test for establishing loss causation should be based upon the principles of corporate finance that govern stock prices and

that have increasingly been applied in other contexts. Under basic principles of corporate finance theory, as described above, the stock price of a company reflects the market's estimation of the company's future cash flows, discounted back to the present. *See supra* Section I.B. In other words, the market price of a publicly-traded stock is based on the public's projections of how that company is going to perform in the future. *See* Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. Rev. 137, 147 (1991). Where a company publicly discloses its *present or past* financial performance, the market will use this information as an indicator of the company's *future* performance. *See supra* note 8. Thus, a disclosure (whether of current performance or anticipated future performance) that causes the market to believe that future performance will fall short of expectations, will deflate a stock price. If it is later revealed by the company or another source that the initial expectations upon which investors relied were based upon fraudulent reporting of past or present results, investors have been victimized by the fraud, even if the admission that fraud has occurred was subsequent to a stock price decline.

Accordingly, where a defendant makes a materially misleading statement to the investing public that artificially inflates the stock price of a company, and the plaintiff, in reliance on the market price of those securities as manipulated by the defendant, purchases the company's stock at such artificially inflated prices, the plaintiff should be deemed to have suffered a loss caused by the defendant to the extent of the inflation so long as the stock price no longer is being propped-up by the fraud. Thus, loss causation should be found even where the disclosures that contradict the earlier, fraudulent statements appear, when made, merely to be the report-

ing of truthful information about the company. The questions are: (i) was the stock price inflated by fraud; and (ii) has the inflation been removed?

The following hypothetical will demonstrate the application of the proposed test. Assume that ABC, Inc. has sufficient real cash flow for the present and future such that its stock should properly be valued at $50 per share. Assume further that management fraudulently reports revenues by reporting sham sales to XYZ Corp. that were not real transactions in quarters one to ten such that, based upon the discounted future value of its (artificially inflated) cash flow, the market concludes the company is worth $75 per share, even though, in reality, it is worth only $50 per share. Our plaintiff purchases stock at this point in time at $75 per share.

Finally, assume that XYZ Corp. files for bankruptcy at the end of quarter ten. From that point in time forward, ABC knows it will no longer be able to book the sham transactions. It promptly discloses that its future performance will be somewhat less than was previously expected (but not why) and, over quarters eleven to sixteen, releases revenue numbers, with attendant cash flows, that result in a company with a value of only $40 per share. At the end of quarter sixteen, ABC announces that the revenue and cash flow numbers from quarters one to ten were fraudulent, but that its current numbers are correct and, indeed, that its future numbers will be improved due to a lucrative new contract. Its stock price stays at $40 per share.[10]

Under the above facts, the plaintiff has been defrauded and, under the test we postulate, should be able to prove loss causation and recover damages for the difference

[10] Of course, it is possible in this scenario that the stock price would increase.

between the purchase price ($75 per share) and the true value ($50 per share), but not for any decline in excess of $25 per share, since any such decline would be unrelated to the fraud.

Utilizing this test for loss causation is fully consistent with the vast majority of existing loss causation jurisprudence and is also consistent with basic principles of corporate finance. So long as a plaintiff can show that the fraud resulted in expectations of improved performance, raising the stock price, and that the revelation of information related to the fraud resulted in expectations of reduced future performance, reducing the stock price, plaintiff should be deemed to have established that the fraud "caused" the loss at issue.

II. THE STANDARD OF LOSS CAUSATION PROPOUNDED BY THE NINTH CIRCUIT OR AN EQUIVALENT STANDARD IS APPROPRIATE AT THE PLEADING STAGE

In its decision in *Broudo*, the Ninth Circuit addressed a case in which a securities fraud lawsuit was brought as the result of two allegedly fraudulent statements. Petitioner Dura Pharmaceuticals, Inc. (Dura) developed and marketed products for the treatment of allergies, asthma, and other respiratory conditions. In 1995, it began developing a delivery device for asthma drugs called Albuterol Spiros. The following year, it began selling a respiratory antibiotic called Ceclor CD. In an April 15, 1997 press release announcing better-than-expected results for the first quarter of 1997, Dura stated that "strong progress" had been made in selling Ceclor CD, and that certain testing had been completed that would allow Dura to submit a new drug application ("NDA") for Albuterol Spiros to the Food and Drug Administra-

tion ("FDA"). Dura filed its application for Albuterol Spiros in November 1997.

On February 24, 1998, Dura announced that, for a number of reasons, including slower than expected sales of Ceclor CD, it was anticipating lower revenues and earnings per share in 1998 than had previously been forecast. The next day, the price of Dura stock dropped 47 percent. The announcement did not mention Albuterol Spiros. In November 1998, Dura announced that the FDA had decided not to approve Albuterol Spiros, "due to electro-mechanical reliability issues and chemistry, manufacturing, and control concerns." The complaint did not allege any decline in Dura's stock price after the November 1998 disclosure.

In reversing a district court opinion that dismissed the Albuterol Spiros allegations for failure to adequately plead loss causation, the Ninth Circuit adopted a notice pleading standard for loss causation. The Ninth Circuit held that loss causation is satisfied where "the plaintiff shows that the misrepresentation touches upon the reasons for the investment's decline in value." 339 F.3d at 938. While the court also stated that "loss causation . . . merely requires pleading that the price at the time of purchase was overstated and sufficient identification of cause," that requirement is not inconsistent with notice pleading, which would not require a discussion of the specific disclosures that materially impacted the stock price. *Id.* This is the appropriate pleading standard and, as a result, the decision of the Ninth Circuit should be affirmed.

Allegations regarding loss causation have been determined by the lower courts to be subject to the liberal pleading requirements of Rule 8 of the Federal Rules of Civil Procedure. *See, e.g., Gebhardt,* 335 F.3d at 830 n.3 (the PSLRA does not change the traditional pleading

rules for materiality and loss causation).[11] Under Rule 8(a)(2), a complaint must include only "a short and plain statement of the claim showing that the pleader is entitled to relief." Such a statement need only "give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Conley v. Gibson,* 355 U.S. 41, 47 (1957). Other portions of Rule 8 reinforce this notice pleading standard. Rule 8(e)(1) states that "[n]o technical forms of pleading or motions are required," and Rule 8(f) provides that "[a]ll pleadings shall be so construed as to do substantial justice." Thus, "[a] court may dismiss a complaint only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Hishon v. King & Spalding,* 467 U.S. 69, 73 (1984).

Under this liberal pleading standard, and the standard for loss causation proposed by the Public Pension Funds above (*see supra* Section I.C), a plaintiff should be required merely to allege a "short and plain statement" that there is some potential linkage between a company's disclosures related to the fraud and the expectations of reduced performance (and hence share price) on the part of the securities at issue. Such a statement is not materially different from the standard adopted by the Ninth Circuit in *Broudo,* since neither standard requires a plaintiff to state with any detail the specific factual statements made by a defendant that are related to the fraud.

This Court should not adopt a more stringent standard for pleading loss causation. Requiring a plaintiff to identify, with particularity, each statement made by a defendant that had the effect, for cash flow purposes, of revealing some aspect of the fraud is a complex, information-inten-

[11] Petitioner has not argued, or even suggested, that a heightened pleading standard is required for loss causation.

sive process that is not appropriate at the pleading stage under Fed. R. Civ. P. 8(a). Such a standard would be inconsistent with notice pleading, would necessitate discovery and extensive expert analysis, and, inevitably, would result in the dismissal of meritorious cases.

The determination of the pleading standard applicable to loss causation requires the Court to balance the legitimate needs of defrauded investors in having access to a legal remedy under the federal securities laws against the needs of business to be protected from meritless litigation. The test proposed by the Public Pension Funds, with notice pleading required for loss causation, adequately strikes that balance. Under Rule 9(b), "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. P. 9(b). Further, the PSLRA requires that a "complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, [a] complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). The PSLRA further mandates that a complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Thus, every complaint, in order to survive a motion under Rule 12(b)(6), must identify, with particularity every fraudulent statement, why it is false, and must set forth facts that strongly infer that the false statements were made recklessly or with knowledge of their falsity. A complaint that has met these very high hurdles is not a frivolous pleading and it is not burdensome for defendants to be required to defend an action that avers in detail why they

knowingly or recklessly made fraudulent statements that impacted the price of a stock.

Requiring, in pleading loss causation, anything more than a basic averment that the fraud caused the loss, on the other hand, would raise the pleading bar so high that a large number of meritorious claims would be precluded at the pleading stage. As described above, in order to adequately plead loss causation in many complex cases where the corrective statements are not labeled as such, a heightened pleading standard would require an extensive event study analysis to determine which corrective statements impacted expectations of performance and, hence, stock price, and the relationship of those corrective statements to the fraud. In many cases, where defrauders have sought to cover their tracks, it will be impossible without detailed analysis like an event study to plead the particular statements that corrected the fraud and thus "caused" the loss. Accordingly, anything more than a general averment that such corrective statements exist, should not be required.

At the pleading stage, the test advocated by the Ninth Circuit, which does not require any substantive link between corrective disclosures and stock price declines, strikes the correct balance between protecting investors and securities fraud defendants. That decision should be affirmed.

CONCLUSION

For the reasons set forth above, *amici curiae* the Public Pension Funds respectfully request that the Court affirm the judgment of the Ninth Circuit in *Broudo v. Dura Pharmaceuticals, Inc.*

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Petitioners,

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Respondents.

On Writ of Certiorari to the United States Court Appeals for the Ninth Circuit

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BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS BROUDO *ET AL.*

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BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS BROUDO *ET AL.*

INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 66 members, including the securities regulators in all 50 states, the District of Columbia, and Puerto Rico. Formed in 1919, it is the oldest international organization devoted to protecting investors from fraud and abuse in the offer and sale of securities.[1]

[1] Pursuant to Sup. Ct. R. 37.6, NASAA represents that no counsel for any party authored this brief in whole or in part, and no person or entity, other than NASAA, its members, or its counsel, made any monetary

The U.S. members of NASAA are responsible for administering state securities laws and regulations. Their activities include licensing firms and their agents, investigating violations of state law, and filing enforcement actions when appropriate. State securities regulators often seek restitution from wrongdoers in enforcement actions to help make injured investors whole. They also promote the adoption and interpretation of state and federal laws that will advance the cause of investor protection.

NASAA supports the work of its members through training programs, investor education initiatives, enforcement support, legislative analysis, and advocacy in the courts. An important role of the association is representing the membership's position, as *amicus curiae*, in significant cases involving the interpretation of the securities laws and the rights of investors. NASAA and its members have a stake in the outcome of this appeal because it will have a widespread impact upon the ability of investors to seek redress in cases where unscrupulous issuers, promoters, or corporate executives have perpetrated a fraud on the market.

The Ninth Circuit correctly ruled that in an action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), plaintiffs alleging fraud on the market meet their burden on loss causation if they plead and prove that the stock price on the date of purchase was inflated because of the defendants' misrepresentations. *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F. 3d 933, 938 (9th Cir. 2003). The court rightly rejected the unrealistic and onerous requirement that there be proof of a "stock price drop following a corrective disclosure" regarding the misrepresentations previously disseminated. *Id.* If this Court were to reverse the lower court

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contribution to the preparation or submission of the brief. Pursuant to Sup. Ct. R. 37.3, NASAA further represents that both parties to this appeal consented to the filing of this *amicus* brief. Copies of their written consents are being filed with this brief.

and establish the more burdensome standard as the federal rule on loss causation, many victims of securities fraud will lose the opportunity to recover their damages. Accordingly, on behalf of its members, NASAA has an interest in supporting the Respondents and advocating for affirmance.

SUMMARY OF THE ARGUMENT

The Ninth Circuit correctly held that plaintiffs seeking recovery under Section 10(b) of the 1934 Act for a fraud on the market can satisfy their pleading burden as to the element of loss causation by alleging that the stock price on the date of purchase was inflated because of the defendants' misrepresentations. The rule advanced by the Petitioners, suggesting that plaintiffs must instead allege a corrective disclosure followed by a price drop in order to survive a motion to dismiss, should be rejected. The federal statute at issue does not impose this requirement, the more burdensome standard is unnecessary to protect wrongdoers from baseless claims, and application of the Petitioners' restrictive rule thwarts the goals of the federal securities laws by depriving injured investors of a judicial remedy for fraudulent misconduct.

ARGUMENT

I. THE NINTH CIRCUIT'S FORMULATION OF THE LOSS CAUSATION STANDARD SERVES THE PURPOSES OF THE FEDERAL SECURITIES LAWS WITHOUT COMPROMISING THE AIMS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT

The Ninth Circuit ruled that the burden of pleading loss causation is met where the complaint (1) alleges that the stock price at the time of purchase was overstated, and (2) sufficiently identifies the cause of the overvaluation. *Broudo*, 339 F.3d at 939. This formulation of the loss causation

standard is correct because it is supported by the plain language of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Congressional intent as expressed in the legislative history, and most importantly, the policies underlying the federal securities laws. The Ninth Circuit's ruling should therefore be affirmed.

In PSLRA, Congress codified the loss causation standard in simple terms: "[T]he plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." *See* Section 21D(b)(4) of PSLRA, 15 U.S.C. § 78u-4(b)(4). Congress thus adopted the common law element of loss causation, but it did not require the plaintiff to prove that element according to any particular formula. The language of the statute offers no support for the Petitioners' contention that causation can only be established through the often unattainable evidence of a corrective disclosure followed by a price drop. Under PSLRA, it is quite sufficient for plaintiffs to plead and prove that "the price on the date of purchase was inflated because of the misrepresentation." *See Broudo*, 339 F.3d at 938, quoting *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996), *cert. denied*, 519 U.S. 1112 (1997).

The legislative history of PSLRA supports this reading of the statute. In explaining the causation requirement set forth in Section 21D(b)(4) of PSLRA, 15 U.S.C. § 78u-4(b)(4), the Conference Report states: "For example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission." H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. The Ninth Circuit's ruling conforms precisely to this expression of legislative intent. Exactly how a plaintiff satisfies this burden of proof is a matter that Congress left to be determined at trial, not at the pleading stage and not pursuant to the rigid

formula advocated by the Petitioners. While proof of a corrective disclosure followed by a drop in the stock price might serve in a particular case as evidence of the degree of price inflation, it is not, and should not be, the exclusive road to recovery. *See Blackie v. Barrack*, 524 F.2d 891, 909 n.25 (9th Cir. 1975) (post-disclosure drop in price is circumstantial evidence of inflation at the time of purchase, but it is not the exclusive measure of inflation), *cert. denied*, 429 U.S. 816 (1976); Michael J. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 Ind. L. Rev. 357, 389 (1991) ("post transaction declines . . . may at most provide the evidentiary starting point for an analysis of the amount by which the fraud altered the transaction price").

The Petitioners counter by arguing that in PSLRA, Congress intended to adopt the rule of loss causation set forth in case law existing at the time of the statute's enactment. *See* Petitioners' Opening Brief at 22-26. Assuming this claim is true, it does not support the Petitioners' analysis of loss causation. The two cases they cite that predate enactment of PSLRA *do* stand for the proposition that plaintiffs must establish loss causation, but they *do not* stand for the proposition that plaintiffs must do so only through an analysis of the market's reaction to corrective disclosures. For example, in *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983), the court formulated the out-of-pocket measure of damages in terms of "the difference between the price paid and the 'real' value of the security, i.e., the fair market value absent the misrepresentation, *at the time of the initial purchase by the defrauded buyer.*" *Id.* at 556 (emphasis added). The court acknowledged the formidable "valuation problems" flowing from this rule, but nowhere indicated that the answer necessarily lies in post-disclosure price movements. *Id.*

In *Bastien v. Petren Resources Corp.*, 892 F.2d 680 (7th Cir.), *cert. denied,* 496 U.S. 906 (1990), also cited by the Petitioners, the Seventh Circuit held that loss causation was a required allegation, but did not prescribe the corrective disclosure and price deflation formula that the Petitioners urge upon this Court. On the contrary, the court in *Bastien* suggested that industry surveys establishing the general success of oil and gas ventures during the relevant time period would have supported an inference and an allegation that the failure of the defendants' operation must have been due to managerial incompetence. *Id.* at 685. Under *Bastien*, this would have satisfied at least the pleading burden on loss causation, insofar as the subject of the alleged deceit in that case was managerial skill and integrity. *Id.* at 682. Viewed in this light, the *Bastien* decision actually supports the Respondents in this case: it leaves them free to ignore specific disclosures and price movements and to base their pleadings on the general proposition that when a pharmaceutical company's leading drug delivery system is rejected by the FDA, the value and price of the company's shares will fall. In short, neither *Huddleston* nor *Bastien* undercuts the legal foundation for the Ninth Circuit's loss causation rule.[2]

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[2] The Petitioners also argue that the Ninth Circuit's ruling on loss causation cannot be reconciled with the "look back" damages provision that Congress adopted in Section 21D(e)(1) of PSLRA, 15 U.S.C. § 78u-4(e)(1). *See* Petitioners' Opening Brief at 15-17. This is incorrect. That provision is an arbitrary cap on the amount of damages that a plaintiff may recover *if* the plaintiff chooses to calculate damages based upon the market price of a stock after the dissemination of corrective information. It does not require causation to be determined according to that formula. Of course, as the Ninth Circuit acknowledged, *see Broudo*, 339 F.3d at 938 n.4, other appellate courts have held that plaintiffs *are* required to demonstrate a corrective disclosure followed by a price drop in order to satisfy the element of loss causation. *See, e.g., Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000), *cert. denied*, 531 U.S. 1149 (2001). In the view of this *amicus*, the rule in those cases is incorrect and should be rejected on the legal and policy grounds discussed above.

The Ninth Circuit's ruling is conceptually sound as well as legally correct. The court was absolutely right in stating that injury occurs at the time the investor pays the inflated price for the stock. *See Broudo*, 339 F.3d at 938. At that point, the investor has been unlawfully deprived of the funds required to pay the fraud-induced component of the stock price. Furthermore, that loss is a direct consequence of the inflationary impact of the defendants' fraudulent misrepresentations. Whether or not the investor is able to recover some portion of that loss is a separate matter of calculating damages. Moreover, investors who are defrauded in this manner suffer an immediate injury that stands entirely apart from whether or not they ultimately recoup some portion of their investment: loss of the use of their money from the moment they invest in the overpriced shares.

The greatest virtue of the Ninth Circuit's ruling is that it serves the underlying purposes of the federal securities laws, whereas the Petitioners' formula undermines those purposes. For decades, this Court has repeatedly declared that the federal securities laws are to be interpreted broadly to effectuate their remedial purposes and to protect investors. *See Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299, 301 (1946). This principle has been applied not only in governmental enforcement actions but in the context of private suits as well. In *Basic Inc. v. Levinson*, for example, the Court held that a presumption of reliance may be applied in fraud-on-the-market cases brought by private litigants, in part because an interpretation of the law "facilitating Rule 10b-5 litigation" supports the Congressional policy embodied in the 1934 Act. *See Basic Inc. v. Levinson*, 485 U.S. 224, 245 (1988). While PSLRA imposed special requirements on private claimants to address certain perceived abuses in class actions, it did not replace investor protection as the preeminent objective of the federal securities laws. When Congress enacted PSLRA, it made this point clear by opening the Conference Report with

the following declaration: "The *overriding* purpose of our nation's securities laws is to protect investors and to maintain confidence in our capital markets . . . ." (emphasis added). *See* H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731.

The Court reaffirmed this guiding principle last year in *SEC v. Edwards*, 540 U.S. 389, 124 S. Ct. 892 (2003). There the Court held that a pay phone sale and leaseback program was an "investment contract" under federal securities law, notwithstanding the respondent's contention that the program offered investors a fixed, as opposed to a variable, rate of return. The Court unanimously rejected the respondent's technical distinction based on rates of investment return, stating that "We will not read into the securities laws a limitation not compelled by the language that would so undermine the laws' purposes." *SEC v. Edwards*, 124 S. Ct. at 897.

Similarly here, the technical formula advocated by Petitioners will seriously undermine investor protection. Meritorious claims involving frauds on the market will be barred in instances where a discrete disclosure followed by a corresponding price correction cannot be identified because of the defendants' ongoing concealment of their misconduct, a confluence of events that mask price correction, or a host of other factors. In those cases, plaintiffs will be unjustly deprived of the right to receive damages for fraudulent conduct that unquestionably caused them injury. Because the Petitioners' interpretation of the loss causation element will "so undermine" the purposes of the securities laws, and because it is neither "compelled" nor warranted by the applicable statutory language, it should be rejected.

The Ninth Circuit's rule avoids this unfairness to investors, and it does so without compromising the goals of PSLRA. Dispensing with the requirement of a corrective disclosure and a correlated price drop will not cause a flood of abusive class action litigation. The Ninth Circuit rule does not give

plaintiffs a free pass on any element of a Section 10(b) fraud claim: it holds them to proof of loss causation by requiring them to establish that the misrepresentations and concealments at issue actually distorted the price paid for the stock. Nor does the rule lead to windfall recoveries. The process of calculating damages accounts for the amount of artificial price inflation, if any, that should fairly be offset against the plaintiffs' claims. *See Blackie v. Barrack*, 524 F.2d 891, 908-09 (9th Cir. 1975) (recovery is limited to actual damages, reflecting any price inflation recouped upon sale), *cert. denied*, 429 U.S. 816 (1976).

II. IF THE NINTH CIRCUIT'S RULING ON LOSS CAUSATION IS REVERSED, AN INCREASING NUMBER OF INVESTORS WILL SUFFER IRRETRIEVABLE LOSSES AT THE HANDS OF THOSE COMMITTING FRAUD

Private actions by defrauded investors are an enormously important complement to regulatory enforcements actions as a means of deterring and remediating securities fraud. State and federal securities regulators work tirelessly to detect, enjoin, and punish financial fraud, and wherever possible, they seek restitution to help make injured investors whole. However, private actions are the principal means of redress for victims of securities fraud, and such actions play a vital role in protecting the integrity of the marketplace. Congress and the courts alike have recognized this fact. The Senate Report accompanying PSLRA described the importance of private rights of action as follows:

> The SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws. As noted by SEC Chairman Levitt, "private rights of action

> are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program." [citation omitted]

See S. Rep. No. 104-98, at 8 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 687; *see also Basic Inc. v. Levinson*, 485 U.S. at 230-31 (observing that the private cause of action for violations of Section 10(b) and Rule 10b-5 constitutes an "essential tool for enforcement of the 1934 Act's requirements"). To the extent that courts erect unwarranted barriers to recovery in private actions, such as the loss causation rule advanced by the Petitioners, investors will suffer.

Ensuring the availability of meaningful private remedies in federal court has become especially important for two reasons: financial crime is on the increase and redress through the state courts is limited. Over the last several years, there has been a marked rise in the incidence of corporate accounting fraud and securities law violations affecting large classes of investors. *See, e.g.*, Press Release, No. 2002-179, *SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices* (SEC, Dec. 20, 2002), *available at* http://www.sec.gov/news/press/2002-179.htm; *see also* Press Release, *State Investigation Reveals Mutual Fund Fraud* (Office of New York Attorney General, Sept. 3, 2003), *available at* http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html. Those violations have harmed millions of investors nationwide, and the trend has not abated. *See* Brooke A. Masters, *Spitzer Targets Insurance Brokers,* Washingtonpost.com, Oct. 14, 2004 (describing the New York Attorney General's recently announced investigation of widespread corruption in the insurance industry), *available at* http://www.washingtonpost.com/ac2/wp-dyn/A34083-2004Oct14?language=printer. These developments illustrate the need for more access to the courts for injured investors, not less.

Congress recognized the seriousness of the problem, and the need for a legislative response, when it enacted the Sarbanes-Oxley Act of 2002. The House Report accompanying the House bill aptly describes the problem of deceptive corporate practices that harm investors:

> The collapse of the Enron Corporation provided irrefutable evidence of serious, systemic problems in our financial reporting system and our capital markets. Far from being an isolated instance, Enron was only the most spectacular example of what has become a common phenomenon—earnings manipulation and deceptive accounting by our largest companies. Before Enron, company after company—Waste Management, Sunbeam, Cendant, W.R. Grace, and many others—were found to have manipulated their accounting to present a picture to investors that did not match reality. As evidenced by the record number of investigations opened by the SEC thus far this year [2002], the problem has only become more acute.

See H.R. Rep. No. 107-414 (2002), 2002 WL 661614, *47 (Minority Views).

The stated purpose of the Sarbanes-Oxley Act is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws." *See* Pub. Law 107-204, at 1, 116 Stat. 745 (2002) (codified at 15 U.S.C. § 7201 *et seq.*). In one provision aimed directly at improving the plight of wronged investors, Congress extended the statute of limitations applicable to private actions for securities fraud. *See* 28 U.S.C. § 1658. Congress thus recognized the need to "reduce procedural barriers to meritorious suits." *See Small v. Fritz Cos., Inc.*, 65 P.3d 1255, 1261 (Cal. 2003) (deciding that shareholders induced to hold stock rather than sell it may bring common law action for fraud). For the most part however, the laudable provisions of Sarbanes-Oxley are focused on enhancing the regulatory oversight of corporate accounting practices and

toughening the penalties for violations of the securities laws. *See, e.g.*, Title I, 15 U.S.C. §§ 7211-19 (establishing an accounting oversight board for public companies); Title VIII, Section 807, 18 U.S.C. § 1348 (increasing criminal penalties for defrauding shareholders of publicly traded companies). It remains for the courts to interpret the securities laws in a manner that affords investors an adequate means of redress for corporate malfeasance.

A second factor weighing in favor of the Ninth Circuit's rule is the limited availability of alternative recourse in the state courts. This Court has observed that the disadvantages posed by a restrictive interpretation of federal securities law can be "attenuated" where adequate remedies are available under state law. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 n.9 (1975) (standing to bring private cause of action under Rule 10b-5 limited to actual purchasers or sellers). Conversely, where state law does not offer a significant alternative forum for plaintiffs' claims, there is a correspondingly greater justification for the federal courts to afford relief.

In this case, state law offers limited recourse for investors in the Respondents' position. Congress has expressly limited the use of class action suits seeking recovery for securities fraud under state law. In 1998, Congress enacted the Securities Litigation Uniform Standards Act ("SLUSA") to address the concern that "securities class action lawsuits [had] shifted from Federal to state courts" as a means of circumventing PSLRA. *See* 15 U.S.C.A. § 78a (Notes (2) and (5)). With certain exceptions, SLUSA provides that no class action based upon state law may be maintained in any state court on behalf of more than 50 class members. *See* 15 U.S.C. § 77p(b). Moreover, state common law generally does not recognize the doctrine of fraud-on-the-market, further limiting the state courts as an alternative forum for investors aggrieved by large-scale market manipulation of the sort alleged

in this case. *See, e.g., Kaufman v. i-Stat Corp.*, 754 A.2d 1188, 1193-94 (N.J. 2000) (reliance may not be satisfied through a fraud-on-the-market theory); *Mirkin v. Wasserman*, 858 P.2d 568, 584 (Cal. 1993) (same).[3]

Precisely because of the massive corporate frauds that have surfaced in recent years, some state courts have recognized the need to reevaluate barriers to civil actions alleging securities fraud. The California Supreme Court, for example, has cited the troubling increase in corporate fraud as a reason to recalibrate the balance between the interests of investors and the interests of corporations, in favor of providing greater judicial recourse to victims of fraud:

> When Congress enacted the Private Securities Litigation Reform Act of 1995 and the Uniform Standards Act of 1998, it was almost entirely concerned with preventing nonmeritorious suits. (Stout, supra, 38 Ariz. L. Rev. 711). But events since 1998 have changed the perspective. The last few years have seen repeated reports of false financial statements and accounting fraud, demonstrating that many charges of corporate fraud were neither speculative nor attempts to extort settlement money, but were based on actual misconduct. "To open the newspaper today is to receive a daily dose of

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[3] The Uniform Securities Act, as adopted and revised in 1956, 1985, and 2002, has served as the model for the majority of state securities laws. It imposes statutory civil liability for securities fraud, but specifically targets those who offer or sell securities. *See* Unif. Sec. Act of 1956, § 410; Unif. Sec. Act of 1985, § 605; Unif. Sec. Act of 2002, § 509. The measure of damages under the Uniform Securities Act, as under several provisions of the federal securities laws, is essentially a rescissionary formula. *Id.* In the relatively few instances where state courts have had occasion to address the element of loss causation, they have done so in connection with claims brought under state statutory provisions, not the common law, and they have readily held that loss causation is not a required element of the plaintiff's case. *See Duperier v. Texas State Bank*, 28 S.W.3d 740, 753-54 (Tex. Ct. App. 2000); *Hines v. Data Line Systems, Inc.*, 787 P.2d 8, 12-13 (Wash. 1990).

> scandal, from Adelphia to Enron and beyond. Sadly, each of us knows that these newly publicized instances of accounting-related securities fraud are no longer out of the ordinary, save perhaps in scale alone." (Schulman, et al., The Sarbanes-Oxley Act: The Impact on Civil Litigation under the Federal Securities Laws from the Plaintiff's Perspective (2002 ALI-ABA Cont. Legal Ed.) p.1.) The victims of the reported frauds, moreover, are often persons who were induced to hold corporate stock by rosy but false financial reports, while others who knew the true state of affairs exercised stock options and sold at inflated prices. (See Purcell, The Enron Bankruptcy and Employer Stock in Retirement Plans, Congressional Research Service (Mar. 11, 2002).) Eliminating barriers that deny redress to actual victims of fraud now assumes an importance equal to that of deterring nonmeritorious suits.

See Small v. Fritz Companies, Inc., 65 P. 3d 1255, 1263-64 (Cal. 2003) (a person wrongfully induced to hold stock may bring an action for fraud under state common law); *see also Murphy v. BDO Seidman, LLP*, 6 Cal. Rptr. 3d 770, 782 n.12 (Cal. Ct. App. 2003) (noting that recent scandals "support revisiting the fraud-on-the-market doctrine").

As long as limitations on recovery persist under state law, investors must depend upon the federal courts to afford complete relief where corporate executives and others have perpetrated a fraud on the market. As financial crimes abound and as alternative forums for aggrieved investors remain limited, it is especially important that the federal courts interpret federal law in a way that affords meaningful remedies to victims of securities fraud.

CONCLUSION

For the reasons set forth above, the decision of the Ninth Circuit should be affirmed.

Respectfully submitted,

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DURA PHARMACEUTICALS, INC., et al.,

Petitioners,

v.

MICHAEL BROUDO, et al.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF AMICUS CURIAE THE REGENTS OF THE UNIVERSITY OF CALIFORNIA IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICUS CURIAE[1]

Article IX, section 9 of the California Constitution grants The Regents of the University of California ("The Regents") "full powers of organization and government" over the University of California. As fiduciary for the University's pension and endowment funds, which invest approximately $53 billion in publicly traded U.S. securities, The Regents has a strong interest in the continued ability of our nation's securities laws to promote transparency and integrity of the securities markets. In February 2002, the United States District Court for the Southern District of Texas appointed The Regents to be lead plaintiff representing a class of investors who purchased securities of the Enron Corporation. *Newby v. Enron Corp. (In re Enron Corp. Securities Litigation)*, 206 F.R.D. 427 (S.D. Tex. 2002). The Regents' experience as lead plaintiff in *Enron* will assist the Court in evaluating the implications of its decision for cases involving complex fraudulent schemes.

SUMMARY OF ARGUMENT

Petitioners propose a false choice between two extreme views of loss causation. They claim that the Ninth Circuit has permitted securities fraud plaintiffs to recover based on a mere showing that defendants' fraud caused

[1] No counsel for any party authored this brief in whole or in part. No person or entity other than The Regents has made a monetary contribution to the preparation or submission of the brief. Petitioners and respondents have consented to the filing of this brief. Their letters of consent have been filed with the Clerk of the Court.

price inflation at the time plaintiffs bought securities.[2] They posit as the only alternative to this approach an inflexible rule under which plaintiffs must demonstrate that the price of the securities fell in response to disclosure of each defendant's fraud. The proper loss causation rule in a price-inflation case such as this one falls between these extremes and requires plaintiffs to prove that: (1) defendants' fraud caused plaintiffs to pay an inflated purchase price for the securities at issue; and (2) plaintiffs did not recoup all of that price inflation through sale of the securities. Plaintiffs need not demonstrate that a disclosure of the fraud led to a decline in the market price of the security to make either showing.

For over a century, this Court has recognized that the "loss" for which plaintiffs seek to recover damages in price manipulation cases is their "out-of-pocket" loss; that is, the difference between the true value of the securities and the fraud-influenced transaction price. Plaintiffs' out-of-pocket loss is mitigated to the extent that plaintiffs both buy and sell securities at a fraud-inflated price. Plaintiffs must therefore show that they did not recoup their loss by selling into the market at an equally inflated price. But this does not mean that plaintiffs can prove loss causation *only* by proving that a corrective disclosure of the fraud was followed by a stock price drop. "There is . . . more than one way to demonstrate the causal connection." *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

[2] This is a caricature of Ninth Circuit precedent, since that court has made clear that plaintiffs must also demonstrate that inflation was reduced or eliminated prior to their sale. *See Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 & n.4 (9th Cir. 1987).

Petitioners' rigid rule is based on twin errors. *First*, it confuses the concepts of "value" (the price that the market would set based on truthful information) and "price" (the price that the market sets in fact) with "artificial inflation" (the difference between value and price). Proper analysis of plaintiffs' loss focuses on *artificial inflation*: if fraud-caused price inflation plaintiffs pay when they purchase a security cannot be fully recovered through sale, plaintiffs have suffered a loss caused by defendants' fraud. Changes in the amount of artificial inflation may be independent of price movement; as the United States demonstrates, artificial inflation may be reduced or eliminated even when the stock price *increases*. *Second*, petitioners and some lower courts have incorrectly assumed that the *only* means by which artificial inflation can be eliminated from the market price of a security is through disclosure of the truth. In fact, many other factors, including both company-specific and market-wide developments, can reduce artificial inflation. Where artificial inflation is reduced prior to plaintiffs' sale, regardless of the reason, plaintiffs incur a fraud-caused loss because they cannot recoup the full amount of their fraud-caused overpayment.

The Enron debacle provides a graphic demonstration of the perverse consequences that would result from application of the loss causation rule petitioners propose. The *Enron* defendants are alleged to have engaged in a wide-ranging, long-lasting, and diabolically complicated fraud – effectively the largest Ponzi scheme in American corporate history – causing millions of investors to overpay for Enron's nearly worthless securities. When the scheme finally collapsed and Enron went bankrupt, these investors suffered terrible losses. Yet, employing petitioners' loss causation analysis, various defendants contend that

they are immune from liability because their role in the scheme was not disclosed until after Enron's collapse, when disclosure could have no further price effect. That argument reveals how petitioners' one-size-fits-all corrective-disclosure requirement creates a "disclosure lottery" in which those defendants that are most successful in hiding their role and least forthcoming in disclosing the fraud are immunized from liability. Such a rule furthers no policy of the securities laws and undermines the ability of deserving plaintiffs to recover from culpable defendants.

ARGUMENT

I. PROOF OF LOSS CAUSATION REQUIRES NEITHER A CORRECTIVE DISCLOSURE OF THE FRAUD NOR A FRAUD-CAUSED DECLINE IN THE STOCK PRICE.

A. Plaintiffs' Loss Is the Unrecouped Inflation that Defendants' Fraud Added to the Purchase Price of Securities.

Statutory interpretation begins with the language of the statute. *See Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 24 (1977). The 1995 Private Securities Litigation Reform Act ("PSLRA") added a "loss causation" section to the 1934 Securities Act, which provides: "In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). Nothing in this text requires plaintiffs to show that defendants' fraud caused a decline in investment price, nor does it define or limit the nature of the loss for which plaintiffs can claim damages. It provides only that

plaintiffs bear the burden of proving that defendants' fraud caused whatever loss plaintiffs claim.

A central error in petitioners' and some lower courts' loss causation analyses is their failure to remain clear about the nature of plaintiffs' claimed loss. Petitioners repeatedly refer to plaintiffs' "loss" as a decline in the value of their stock. *See, e.g.*, Pet. Br. at 4-5, 11. In fact, this Court and lower courts have recognized for over a century that the primary measure of injury when a plaintiff is fraudulently induced to purchase or sell securities is the plaintiff's "out of pocket" loss; that is, the difference between the transaction price and the true value of the security at the time of the transaction.[3] *E.g.*, *Randall v. Loftsgaarden*, 478 U.S. 647, 661-62 (1986) ("[O]rdinarily 'the correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct. . . . '" *quoting Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972)); *Sigafus v. Porter*, 179 U.S. 116, 123 (1900) ("The true measure of the damages suffered by one who is fraudulently induced to make a contract of sale, purchase, or exchange of property is the difference between the actual value of that which he parts with and the actual value of that which he receives under the contract."); *Smith v. Bolles*, 132 U.S. 125, 130-31 (1889) (applying same rule to stock fraud case); *Sowell v. Butcher & Singer, Inc.*, 929 F.2d 289, 297 (3d Cir. 1991) (In 10b-5 cases "a plaintiff's damages are most commonly calculated as the difference

[3] "True value" is merely the price that the market would have set absent the fraud. *See Sowell v. Butcher & Singer, Inc.*, 929 F.2d 289, 297-98 (3d Cir. 1991); *see also Basic*, 485 U.S. at 246.

between the price paid for a security and the security's 'true value'."); *Alley v. Miramon*, 614 F.2d 1372, 1387 (5th Cir. 1980) (same). Even courts that have imposed a "disclosure/price correction" rule have – at least initially – accepted out-of-pocket damages as the proper measure of plaintiffs' loss. *E.g., Semerenko v. Cendant Corp.*, 223 F.3d 165, 184-85 (3d Cir. 2000); *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 n.5 (11th Cir. 1997).[4] These decisions recognize the simple point that "[p]aying more for something than it is worth is damaging." *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

Application of the out-of-pocket rule is consistent with the purpose of the 1934 Act, which is not to guard against stock price declines, but "to protect investors against manipulation of stock prices." *Lampf, Pleva, Lipkin, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360-61 (1991); *Basic,* 485 U.S. at 230. It is also consistent with the legislative history of section 78u-4(b)(4) in which Congress noted that loss causation may be shown "[f]or example" by proving "that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission." H.R. Conf. Rep. No. 369, 104th Cong., 2d Sess. 41 (1995).

Unlike petitioners, the United States recognizes that plaintiffs' loss arises from artificial inflation of the plaintiffs' purchase price. The United States, along with many lower courts, also correctly notes that plaintiffs' loss is mitigated to the extent that inflation remains reflected in

[4] Yet *Semerenko* and *Koger* err by later inconsistently characterizing plaintiffs' loss as a decline in "value" or "price." *Semerenko.*, 223 F.3d at 185; *Koger Properties, Inc.*, 116 F.3d at 1448.

the stock price at the time the defrauded investor sells. Brief of U.S. at 15 et seq. Therefore, if the amount of fraud-induced inflation at the time a plaintiff sells equals the amount of inflation at the time he bought, he has suffered no damage at all because he is in exactly the same net position he would have been in without the fraud. Brief of U.S. at 21. Conversely, if the amount of artificial inflation has been reduced between the time of plaintiff's purchase and sale, the plaintiff has necessarily suffered damage caused by the fraud because he has made a fraud-induced "overpayment" that he is unable to fully recoup.

To illustrate these points, assume an investor purchases a stock worth $8 at a fraud-inflated price of $10. If artificial inflation remains $2 when the investor sells, whether the stock price rises or falls, he has suffered no loss because he is able to recover the $2 and remains in the same net position he would have been but for the fraud. If, on the other hand, all inflation is eliminated from the stock price, but its true value remains constant and the investor sells for $8, he has plainly suffered a $2 loss caused by the fraud. Alternatively, if inflation is eliminated but the true value had increased to $9, the investor would still be "out of pocket" $2, since, in the absence of the fraud he would have paid only $8 and reaped a $1 profit instead of a $1 loss. Similarly, if inflation is eliminated and the true value declines to zero, the investor's fraud-caused loss remains $2, since absent the fraud he would have lost $8, not $10.

As the United States also demonstrates, changes in the amount of artificial inflation need not be accompanied by movement of the stock price, and the presence of a true out-of-pocket loss is not dependent on a drop in the price of

plaintiffs' stock. Brief of U.S. at 19-20. For example, disclosures that eliminate artificial inflation might be offset by a contemporaneous public announcement of positive news, and therefore elimination of inflation might be accompanied by a net *increase* in price. *Id.* Similarly, an *increase* in the amount of artificial inflation may occur without an increase in the price of the stock, as when a company fails to make a required disclosure of material negative news that would have caused the price of its stock to decline. The introduction of artificial inflation into the price of a stock may even be accompanied by a price *decrease*, as when the perpetrators announce false positive news in an attempt to soften the price decline caused by contemporaneous publication of some negative development. Like petitioners, some courts have incorrectly asserted that plaintiffs must show that the stock price changed in order to prove that the fraud influenced the transaction price. *E.g.*, *Greenberg v. Crossroads Systems, Inc.*, 364 F.3d 657, 662 (5th Cir. 2004) (plaintiffs must demonstrate stock price "was actually affected by the allegedly false statements, either by showing an increase in price following the allegedly false positive statements or a corresponding decrease in price following the revelation of the misleading nature of these statements").[5] "Litigants and courts" who have suggested that price changes must accompany changes in artificial inflation "are mistaken." Brief of U.S. at 19. The correct

[5] This incorrect conclusion has led courts to all sorts of corollary errors. In *Greenberg*, for example, the Fifth Circuit also held that "confirmatory" statements could not be actionable because they do not affect the stock price. 364 F.3d at 663. This ignores the possibility that a statement that confirms rather than contradicts a misrepresentation may extend the period during which the stock price is artificially inflated, thereby injuring additional investors.

inquiry is whether artificial inflation was caused by defendants' fraud and whether that inflation was reduced prior to plaintiffs' sale.

Therefore, before recovering damages for fraud under the 1934 Act, each plaintiff must show that artificial inflation was reduced or eliminated prior to plaintiff's sale of the investment. This requirement falls at the intersection of loss causation and proof of damages, and it is immaterial of which inquiry it is considered a part. Nevertheless, it is worth noting that, in practice, analyses of the amount of damages in securities litigation typically incorporate any mitigating sale price inflation. Damages are usually proven by expert studies that seek to construct a "value line" charting the true value of the securities over time, thereby indicating the amount of inflation – that is, the difference between the "value line" and the actual market price – on each day of the relevant period.[6] Damages for each plaintiff are calculated by subtracting the amount of inflation on the date of plaintiff's sale from inflation on the

[6] Several *amici* argue that specific expert methodologies are the only valid means to quantify plaintiffs' damages. *See, e.g.*, Brief of Securities Industry and Bond Market Associations at 9-10 (backcasting event study analysis); Brief of Broadcom Corp. at 10 (dollar versus percentage decline measure of loss). This case – which is currently only at the pleading stage and in which conflicting expert methodologies have not even been presented to, much less ruled on by, the trial court – does not require this Court to address that issue. It is sufficient to note that determination of an appropriate damages methodology is a complex question, the correct answer to which may vary with the circumstances of each case. *See, e.g.*, Crew, Goshtigian, Moore & Sarin, "Securities Act Violations: Estimation of Damages," in Litigation Services Handbook, The Role of The Financial Expert at 17.14 (3rd Edition, 2001) Weil, Wagner & Frank, eds.; Tabak & Okongwu, "Inflation Methodologies in Securities Fraud Cases: Theory and Practice," NERA Working Paper at 3-4 (July 2002).

date of plaintiff's purchase. *See, e.g., In re Cendant Corp. Securities Litig.*, 109 F.Supp.2d 235, 264 (D.N.J. 2000), *aff'd*, 264 F.3d 201 (3d Cir. 2001); *In re California Micro Devices Securities Litig.*, 965 F.Supp. 1327, 1333 (N.D. Cal. 1997); Cornell & Morgan, "Using Finance Theory to Measure Damages in Fraud on the Market Cases," 37 U.C.L.A. L. Rev. 883, 886 (1990). Under the type of damage analyses already routinely employed, no plaintiff recovers more than his actual damages.

B. Proof that Defendants' Fraud Caused Unrecouped Inflation Does Not Require a Showing that Disclosure Resulted in a Price Drop.

Thus, the conceptual framework that the United States proposes for analysis of loss causation is the correct one: plaintiffs must demonstrate, not that disclosure of defendants' fraud caused a decline in stock price, but that defendants' fraud caused inflation in their purchase price and that the inflation was reduced or eliminated prior to plaintiffs' sale. Nevertheless, the United States, like petitioners and some lower courts, errs by assuming that artificial inflation may be reduced or eliminated from the stock price *only* through disclosure of the fraud (either through words or "by events"). *See* Brief of U.S. at 7; *see also* Pet. Br. at 13.[7] Causation must be determined on the basis of facts, not blanket assumptions. *See Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 382 n.5 (1970) (rejecting

[7] An associated error is the position of some courts that, where disclosure has not resulted in a price change, the alleged fraud must never have influenced the stock price in the first place. *E.g., Greenberg*, 364 F.3d at 662.

causation analysis based on "dubious" implicit assumption). Elimination of artificial inflation means simply that the effectiveness of the fraud ceases in that it no longer influences the stock price; reduction of inflation means that the fraud has lost some, but not all, of its effectiveness. The effect of a fraud can be reduced or eliminated by circumstances other than disclosure of the truth. *See Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345 (9th Cir. 1977) (Sneed, J., concurring); *In re Initial Public Offering Litig.*, 297 F.Supp.2d 668, 673 (S.D.N.Y. 2003) ("*IPO Litig.*"). Some examples show how:

1. Artificial inflation may dissipate from the price of a security through the passage of time. "[O]rdinary market forces affect the rate of artificial inflation" because in some circumstances "the normal functioning of the securities market causes the inflationary effect to dissipate over time." *IPO Litig.*, 297 F.Supp.2d at 673. In evaluating a company's current condition and future prospects, the market will pay more attention to its most recent results. Therefore, if a corporation misstates quarterly earnings to meet expectations, the inflationary impact of that misstatement is likely to dissipate as increasingly distant historical earnings numbers become less and less important. *See id.* at 674 n.29 ("In some cases, however, the importance of misstatements may diminish over time, and inflationary effect may diminish (or disappear entirely) with it."). While disclosure of the misstatement immediately after it was made may have resulted in a dramatic drop in the stock price, disclosure may have little or no impact if the perpetrators are able to conceal the fraud long enough. Yet investors who bought the stock immediately after the misstatement and held it have been injured: compared to their position had they purchased at

true value, they are "out of pocket" the amount of the inflation, which they cannot recoup by selling. Whether the stock rose or fell in the interim, their investment gain has been reduced, or loss increased, by the fraud. The perpetrators' success at concealment (assuming the statutory period of repose has not expired) should not immunize them from liability.

2. If the market price of a security drops to zero, whatever the cause, it is necessarily true that all artificial inflation has been eliminated from the price. Subsequent disclosure of the fraud can cause no further drop in price. While investors' out-of-pocket loss does not include that portion of the purchase price representing the true value of the stock at the time of their purchase, investors should recover the amount of inflation they paid above that true value – the part of their loss that was caused by the defendants' fraud – whatever the cause of the company's decline. Compared to the position investors would have been in, they are "out of pocket" the amount of inflation they paid at the time of their purchase. Put another way, the amount of their loss in the bankruptcy has been increased by the fraud.

3. Company-specific developments may eliminate artificial inflation. If, for example, a company's stock price is inflated because of false claims it has made about the capabilities of an anticipated product, investors who purchase the stock are injured by paying too much. If the company then announces that it is abandoning the entire segment of its business that includes the new product, any artificial inflation that the false product claims contributed to the stock will be removed since the now-abandoned

product will become irrelevant to the market's evaluation of the company.[8] Although there has been no disclosure of the fraud, investors who purchased the company's stock at the inflated price have been damaged by paying an excessive price they cannot now recoup through sale. Because the market has already discounted the inflationary impact of the fraud, its subsequent disclosure will not affect share price.

4. Market-wide developments may reduce artificial inflation by reducing the importance of fraudulent misstatements. In his concurrence in *Green v. Occidental Petroleum*, 541 F.2d at 1345, Judge Sneed rejected the assumption that the amount of artificial inflation (the "spread" between the "price" and "value" lines) would necessarily remain constant prior to disclosure of the fraud and offered the following example:

> [A] false representation that the corporation has discovered oil will increase in value if the price of oil goes up subsequent to the misrepresentation. Expressed in terms of price and value lines, the spread between the lines increases causing the lines to diverge. A decline in the price of oil, on the other hand, will reduce the value of the misrepresentation and cause the lines to converge.

Id. (footnotes omitted). In this example, if the price of oil declines, and the value of the misrepresentation falls, some artificial inflation has been removed from the stock price. Plaintiffs who sell at that point will suffer a loss

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[8] Nevertheless, if the market believed that – despite its hopes that sales of the new product would mitigate the loss – the overall segment would lose money in the future, the announcement that eliminated the price inflation might result in an *increase* in the stock price.

because not all of the price inflation they paid when they bought the stock will be recaptured through the sale.

As these examples illustrate, the amount of inflation at the time of plaintiffs' purchase and sale can be determined only in light of all the facts peculiar to each case. Yet the rule urged by petitioners would permit courts to look *only* at whether there was a disclosure of the fraud and its impact on price. "Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive." *Basic*, 485 U.S. at 236. Petitioners' proposed rule should therefore be rejected.

The examples above also belie the United States's assertion that the fraud on the market theory implies that artificial inflation must remain in the stock price prior to disclosure of the fraud. *See* Brief of U.S. at 21. The fraud-on-the-market theory posits that efficient markets will react quickly to new material information, *Basic*, 485 U.S. at 246 n.24, but it does not assert that the materiality, and thus the price impact, of any particular piece of information (or misinformation) must remain constant regardless of the passage of time and changing circumstances. On the contrary, since the market responds to *all* available information, *id.* at 246, the theory suggests that, as circumstances change and new information becomes available, the importance that the market places on the fraudulent information may also change. Disclosure of a company's falsification of quarterly earnings that might have been quite material at the time of the earnings announcement will be far less so years later when subsequent performance information is available. A significant fraud may become utterly immaterial to the market's evaluation of a company after the market learns the company is bankrupt.

Material information may become irrelevant if a company's business changes significantly. The importance of information will vary with external market conditions. The market's reaction to fraud disclosure will accurately reflect the materiality of the fraudulent information *at the time of the disclosure,* but it may say little about the importance of the fraud *at the time of plaintiff's purchase* (and therefore little about the dollar amount of artificial inflation the fraud added to plaintiffs' purchase price). Full and unambiguous disclosure of a fraud allows us to presume that artificial inflation has been eliminated, but absence of disclosure does not allow us to presume that it has not.

Similarly flawed is the argument that when fraud-induced inflation is reduced other than by disclosure there has been a "superseding cause" of plaintiffs' loss that relieves the perpetrator of liability. *See* Restatement 2d Torts § 440. First, where the nature of the harm is a foreseeable result of defendants' wrongful act, the fact that it is brought about by some intervening force does not relieve the perpetrator of liability. *See* Restatement 2d Torts § 548A ("A fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from action or inaction in reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance."); *see also* Restatement 2d of Torts, §§ 442A & 442B (where "actor creates or increases the risk of a particular harm . . . the fact that the harm is brought about through the intervention of another force does not relieve the actor of liability. . . ."); 1 D. Dobbs, The Law of Torts § 189 at 466 (2001) (where the "general kind of harm" is foreseeable, defendant "is not normally relieved of liability merely because the manner

of injury . . . [was] unforeseeable").[9] Since nothing lasts forever, it is always foreseeable that defendants' frauds will someday lose their effectiveness thereby reducing or eliminating inflation from the stock price. Therefore, it is reasonable to expect, if not inevitable, that some investors will be left holding the stock when the frauds lose their effectiveness and be unable to recoup their overpayment through sale. The frauds' eventual loss of effectiveness, whether resulting from disclosure or something else, is not a "superseding" cause of injury separate from the fraud, but a natural and foreseeable consequence of the frauds themselves. Second, since the plaintiffs' "loss" is their fraud-induced overpayment, plaintiffs' inability to recoup that overpayment through sale means only that a third party – another buyer – has not mitigated that loss by paying plaintiffs an inflated price for the stock. The failure of a third party to make good plaintiffs' injury is not a "superseding cause" of their loss. *See* Restatement 2d Torts § 452 (failure of third party to prevent harm threatened by

[9] Citations to Restatement § 548A by petitioners (Pet. Br. at 32 n.13 and 33) and the United States (Brief of US at 18) excise the important concept of foreseeablity. *See* Restatement 2d Torts § 548A, comment b. Although § 548A does not expressly analyze causation in the fraud-on-the-market context, it strongly supports The Regents' position. Illustration 2 states, for example, that where the investor "suffers a pecuniary loss" from insolvency that is "greater than that which would have resulted" absent the fraud, the perpetrator "is subject to liability . . . for the additional pecuniary loss." This is exactly the circumstance suggested by example number 2 above, and by the *Enron* facts discussed below, in which investors lost more than they would absent the fraud because of the inflated price they paid. In contrast, the comments and examples that petitioners and *amici* cite stand only for the proposition that when a non-fraud related event causes a decrease in the *true value* of an investment (as when a corporation's leading officers die or a court invalidates municipal bonds), fraud is not the legal cause of that loss.

defendant's conduct "is not a superseding cause of such harm").

Finally, a disclosure requirement is arbitrary not only because it is unnecessary to demonstrate an out-of-pocket loss, but also because it is unconnected, and even contrary, to the goals of the securities laws. Rather than conditioning liability on the fraudulent conduct that those laws seek to deter or on the injury such conduct causes investors, petitioners' rule hinges liability on the existence of circumstances the law should seek to encourage: disclosure that ends the fraud's effect on the market. Perversely, under petitioner's rule it is the defendant who *has* timely disclosed the fraud who becomes liable, while the defendant who hides his fraud long enough is immunized. Such a requirement will bar plaintiffs from recovering the excess they paid as a result of defendants' price manipulation but cannot recover through sale, permit culpable defendants to avoid liability, and affirmatively discourage corrective disclosure.[10]

[10] This Court should reject the contention of petitioners and *amici* that adoption of an arbitrary "disclosure/price-drop" requirement is necessary to prevent introduction of speculative expert damage analyses and the extortionate settlements that would supposedly result. The PSLRA specifically addressed the settlement concern, *see, e.g.*, H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 37-38 (1995), and there is strong evidence that the Act has successfully reduced the problem of nuisance suits. *See* Choi, "Do the Merits Matter Less After the Private Litigation Reform Act?," University of California, Berkeley Law School Public Law & Legal Theory Research Paper No. 558285 at 1-6 (June 23, 2004) (available at http://ssrn.com/abstract=558285). Similarly, this Court has provided district courts with standards to ensure that only reliable expert analysis is admitted into evidence and has expressed confidence "that federal judges possess the capacity to undertake this review." *Daubert v. Merrill Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 593 (1993).

II. A CORRECTIVE DISCLOSURE REQUIREMENT WOULD UNDERMINE IMPORTANT INVESTOR PROTECTIONS IN CASES INVOLVING COMPLEX FRAUDULENT SCHEMES SUCH AS THE ENRON CORPORATION SECURITIES FRAUD CASE.

A. The Enron Scheme.

The plaintiffs' allegations in *In re Enron Corp. Securities Litigation*, describe perhaps the most far-reaching, complex, and long-lasting fraudulent scheme in our nation's corporate history. Many of the roots of the scheme lie in Enron's overly aggressive embrace of mark-to-market accounting, under which the company cannibalized future earnings by booking and reporting all profit that it *projected* would be earned from transactions throughout their lifetime as *actual* profit in the quarter in which the deal closed. *See In re Enron Corp. Securities, Derivative & ERISA Litig.*, 235 F.Supp.2d 549, 622-23 (S.D. Tex. 2002). Because this form of accounting amplified present results at the expense of the future, to maintain the appearance of robust growth Enron was required each quarter to close an ever greater number of transactions that it could "mark-to-market." *Id.* at 623 n.60. This imperative fostered a culture of promiscuous deal-making in which the quality of transactions and their profitable implementation were secondary to simply getting the deal done, and Enron collected a growing portfolio of poor investments. *Id.* Enron's addiction to mark-to-market accounting also created a "disconnect" between its growing reported profits (which were based on projected future results) and actual current cash flows and operational revenue. These conditions, if they became obvious, threatened to undermine Enron's stock price and credit rating,

maintenance of which was essential to the survival of the company's deal-making operation. *See id.* at 631.

Using outsized fees as an inducement, Enron was able to enlist many of the world's largest financial institutions to help it engineer a complex web of so-called "SPE" transactions that enabled the company to conceal these problems and to report ever-increasing profits. *Id.* at 638. As described by the district court:

> The consolidated complaint sets out an elaborate scheme of off-the-books, illicit partnerships, secretly controlled by Enron and established at times critical for requisite financial disclosures by Enron in order to conceal its actual financial status. These Enron-controlled entities typically would buy troubled assets from Enron, which Enron would have had difficulty selling in an arm's length transaction to an independent entity and which otherwise would have to be reported on Enron's balance sheet, by means of sham swaps, hedges, and transfers, to record phony profits and conceal debt on Enron's balance sheet.

Id. at 613-14; *see also id.* at 638. In addition, Enron and its banks engaged in numerous circular "pre-pay" commodities contracts designed to create a false impression of increased cash flow and to hide the company's mounting debt burden. In these transactions, Enron, a financial institution, and a sham entity controlled by the financial institution entered into a series of circular future commodities sales. When the reciprocal trades were offset, the economic effect of the transaction was a loan from the financial institution to Enron. By improperly characterizing them as commodities transactions, Enron was able to report the loan proceeds as cash flow from operations,

thereby massively overstating Enron's operating cash flow and understating its bank debt. *Id.* at 627-29.

Enron's financial misstatements and apparent robust growth led to a soaring stock price, rising from roughly $18 in August 1997 and peaking at over $90 per share in August 2000. Despite their inside knowledge of Enron's phony financial statements, "[t]he banks were central players in inflating and supporting the price of Enron stock through issuance of glowing research reports with misleading information about Enron." *Id.* at 638. But the deception could last only so long. Although there was no disclosure of fraudulent transactions, throughout the first three quarters of 2001, as some market watchers raised public concerns about Enron and events at the company suggested that all might not be well, Enron's share price began to erode. *E.g.*, *id.* at 631. For example, a March 5, 2001 article in *Fortune* was titled: "Is Enron Overpriced? It's in a bunch of complex businesses. Its financial statements are nearly impenetrable. So why is Enron trading at such a huge multiple?" In July 2001, fearing the impending collapse, Enron's CEO Jeffery Skilling unexpectedly announced his resignation. *Id.* at 634. Enron and many of the financial institutions that were heavily involved in the scheme reacted with a furious public campaign to dismiss doubts and maintain Enron's stock price. For example, after Skilling's announcement, Enron and its bankers sought to reassure the market that there was "nothing to disclose" and that Enron's "future had never been brighter." *Id.* at 634-35. Nevertheless, many of the financial institutions began to recognize that the scheme could not be maintained indefinitely, and so attempted to push their exposure to Enron onto other, unsuspecting parties. *Id.* at 632.

Within a few months, the Ponzi scheme started to collapse. As Enron's stock price dropped, many of the SPE deals, which were supported and capitalized by Enron's own stock, began to fail and had to be restructured. *See id.* at 626, 631, 633-34, 636. When restructuring became impossible, Enron was forced to consolidate off-the-books entities and transactions into its own financial statements and to restate prior financial reports, resulting in a cascade of negative partial disclosures that quickly brought down the house of cards. On October 16, 2001, Enron announced that it would take over $1 billion in after-tax write-offs relating to failed investments and a reduction in shareholder equity of $1.2 billion. *Id.* at 636. The next five trading days saw Enron's stock price fall from $33.84 to $19.79. On October 22, Enron announced that the SEC was investigating certain related party transactions, resulting in a further five-day decline to $13.81 per share. On November 8, 2001, Enron announced the need to restate its financial results going back as far as 1997 and conceded that major SPE transactions had been improperly reported. *Id.* Nevertheless, Enron's stock price actually *increased* over the next several days because the company had also announced the prospect of a merger with Dynegy under which shareholders would be paid about $10 per share for their stock. *See id.*; "Enron Admits to Overstating Profits by About $600 Million," *New York Times*, page C1 (November 9, 2001). On November 19, Enron filed a late 10-Q that disclosed a variety of problems relating to the loss of investor confidence and the inability of Enron to obtain credit, and stated that Enron had insufficient cash to make it through the year. Enron's stock price declined from $9.06 to $4.11 during the next five trading days. On November 28, 2001, the failure of the Dynegy merger was announced, causing Enron's share

price to drop from $4.11 to $0.40 over the next five trading days, by which time Enron was in bankruptcy. Enron's stock traded at "salvage" levels – under $1 thereafter.[11]

Thus, by late 2001, the market knew that Enron was a fraudulent company, and the consequences of that fraud – Enron's insolvency – became evident. Nevertheless, because of their complexity and profusion, unraveling all of Enron's fraudulent transactions and discovering the role of each participant required several years and multiple investigations costing more than $100 million. *See, e.g.*, "Enron Bankruptcy Examiner's Fees Soar," *Washington Post*, page E1 (December 30, 2003).

The Enron scheme unquestionably caused losses to the plaintiff class. Defendants' concerted effort to misrepresent Enron's financial condition and create a false appearance of growth caused the market price of Enron stocks and bonds to be artificially inflated far above the true value of the company throughout the class period. Investors who bought shares at inflated prices and held them through Enron's collapse incurred an out-of-pocket loss caused by the fraud. For purchasers who sold prior to bankruptcy, the existence of loss causation (and the calculation of their damages) will require comparison of the amount of inflation at the times of their purchases and sales.

[11] Enron stock price information is available at http://quotes.nasdaq.com/asp/MasterDataEntry.asp?page=Charts.

B. Application of Petitioners' Simplistic Loss Causation Rule to a Complex Fraud Scheme Like Enron's Would Lead to Injustice and Would Undermine Operation of the Securities Laws.

The *Enron* case illustrates how imposing a simplistic "disclosure/price correction" requirement developed in basic misrepresentation cases to complex scheme cases would severely undermine the operation of the securities laws. As this Court has held, section 10(b) covers more than the typical case, and it should not be interpreted in a way that permits perpetrators of unusual frauds to avoid liability. *See Superintendent of Insurance of the State of New York v. Bankers Life and Cas. Co.*, 404 U.S. 6, 10 n.7 (1971).

First, the complexity of the *Enron* facts renders inappropriate and misleading over-reliance on the simplistic paradigm of "misstatement, price increase, disclosure, price drop." In *Enron* there was a profusion of fraudulent transactions and false statements piled one on top of another over an extended period of time, all designed to maintain Enron's inflated stock price. Each quarter, the scheme participants devised new deceptive transactions to maintain the appearance of Enron's prosperity and growth. Any expectation that each individual misstatement or transaction that was part of this deceptive scheme should be accompanied by a discreet price increase reflecting its impact on stock price is naive.

Similarly, the market's recognition of the Enron fraud was far more complex than the paradigm of a single, unambiguous disclosure on which many of the lower-court cases have been based. The dissipation of the dollar amount of artificial inflation that occurred in Enron's stock price in the earlier part of 2001 was not the result of

disclosure of any specific fraudulent transactions but resulted instead from observers raising non-specific questions about Enron's financial strength. Enron and the financial institution analysts sought to minimize these concerns by falsely reassuring the market. These complicating facts confound any expectation that a discreet fraud disclosure should result in a price decline matching the amount of artificial inflation caused by the disclosed fraud. When sufficient elements of the scheme were disclosed in October and November 2001 to cause Enron's stock price to collapse, some portion of the dollar amount of artificial inflation had already been removed from the stock price because of questions that had been raised earlier. Gauging the existence or amount of the loss of those investors who purchased Enron stock at its high-water mark solely on the basis of price declines that occurred when the fraud was explicitly (but only partially) disclosed in late 2001 would ignore relevant facts and understate the investors' true injury.

Second, the *Enron* facts provide a clear example of how artificial inflation may be reduced from the price of a stock without any corresponding price decline. On November 8, 2001, Enron announced that its prior financial statements could no longer be relied upon. Despite this shocking announcement, the price of Enron's stock *rose* slightly over the next several days. Why? Enron simultaneously announced that Dynegy planned to buy Enron at $10 per share, more than the current trading price, thereby buoying Enron's stock price. Petitioner's rule would require that the court and jury look only at the price reaction in the wake of the November 8 disclosure, thereby forcing them to find that the complete falsification of Enron's financial statements from 1997 through 2001 had *no* inflationary impact on Enron's stock price – a facially absurd conclusion.

Third, the Petitioner's proposed rule would assign liability among multiple defendants in a complex fraud case not on the basis of their culpability or the injury their conduct caused investors, but on the basis of each defendant's success in hiding its unlawful conduct. The allegations against Merrill Lynch & Co., Inc. illustrate the point.

On November 3, 2004, four Merrill Lynch executives were convicted of fraud in connection with their role in Enron's "purchase" of certain Enron assets – including some Nigerian Barges – conditioned on an oral side agreement under which Enron would later re-purchase the assets at a profit to Merrill. Enron declared a profit from the sham "sale," allowing it to meet market earnings expectations for the quarter ended December 31, 1999. *In re Enron Corp. Securities, Derivative & ERISA Litig.*, 310 F.Supp.2d 819, 829 (S.D. Tex. 2004). Internal Merrill documents "support a strong inference that Merrill Lynch knew the Nigerian barge deal was a phony transaction created to manipulate Enron's income statements in return for Merrill Lynch's lucrative 15% return." *Id.* Knowing that Enron's earnings numbers were phony, Merrill permitted its securities analysts to issue glowing reports to the public about the company and its prospects. *See id.* at 830. Merrill has executed a letter agreement with the Department of Justice in which it agreed to accept responsibility for the transaction. *Id.* at 829.

The criminal jury specifically found that Merrill's conduct caused a loss to investors. During the late 1990's, failure of growth companies such as Enron to meet analysts' expectations, even by a small amount, usually resulted in a sharp decline in their stock price. *See, e.g.*, Bartholomew, "Is Silence Golden When It Comes to Auditing," 36 J. Marshall L. Rev. 57, 82-83 (2002).

Therefore, Merrill's manipulation of Enron's profit numbers caused Enron's stock price to be higher than it would have been had the market known the truth. Investors who purchased Enron stock in the wake of the phony December 1999 profit announcement paid an inflated price, and those who held the stock until after the Enron bubble burst were unable to recoup their loss. *See In re Enron Securities Litig.*, 310 F.Supp.2d at 832.

Nevertheless, applying the type of loss causation analysis urged by petitioners, Merrill has argued that it should be exempt from liability because the fraudulent transactions in which it participated "were not known to the public until April and August of 2002, respectively, five and nine months after the Class Period ended on November 27, 2001, and long after the price of Enron securities had collapsed." *Id.* at 828 (footnote omitted). In short, Merrill argues that – *even if* it knowingly perpetrated a criminal fraud against investors by scheming to falsify Enron's financial statements and misrepresenting Enron's financial condition in its analyst reports, and *even if* those misrepresentations were material, and *even if* they caused some investors to pay an inflated price for Enron stock, and *even if* those investors were unable to recoup that excess through sale of their stock, thereby realizing a substantial out of pocket loss due to Merrill's fraud – Merrill is immune from liability because it was able to conceal its role in the fraudulent scheme until after the collapse of Enron.

The *Enron* facts illustrate that as increasing information regarding a complex scheme emerges, the market may reach a point – long before all the details have been disclosed – at which it recognizes the inability of the company to sustain operations and the stock price collapses to zero.

Subsequent discovery of additional aspects of the fraud will, of course, have no further price effect. But that does not mean they were immaterial or caused no injury. Whether a particular transaction or participant's role is discovered before or after the "tipping point" may be merely a matter of chance or of the participant's skill in deceiving the market. Petitioners' proposed loss causation standard would establish a "disclosure lottery" in which participants whose injurious, illegal conduct is discovered only after the house of cards collapses are immune from liability, even though they have undoubtedly caused an out of pocket loss to investors. Deserving plaintiffs would be unable to recover from culpable defendants, and some defendants would be required to shoulder a disproportionate share of liability on the basis of chance. Nothing in either the text of purposes of the securities laws supports such an anomalous result.

CONCLUSION

The decision of the Court of Appeals should be affirmed.

Dated: November 17, 2004

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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC., *et al.*,

Petitioners,

v.

MICHAEL BROUDO, *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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INTEREST OF THE *AMICI CURIAE* [1]

The Securities Industry Association ("SIA"), established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers' Association, represents the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. (More information about SIA is available at www.sia.com.)

The Bond Market Association ("TBMA") represents approximately 200 securities firms and banks that underwrite, trade and sell fixed-income securities in the United States and in international markets. TBMA's members transact business in a wide variety of public and private fixed-income securities. Its membership comprises a diverse mix of securities firms and banks, including large, multi-product firms and companies with special market niches. It includes all primary dealers in U.S. government securities, as recognized by the Federal Reserve Bank of New York, and all major dealers in federal agency securities, mortgage-backed and asset-backed securities, corporate bonds, money market instruments, and funding instruments such as repurchase and securities lending agreements. From its inception in 1976,

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[1] Pursuant to this Court's Rule 37.6, *amici* SIA and TBMA state that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amici* and their members made a monetary contribution to the preparation or submission of the brief.

Pursuant to Rule 37.3, *amici* state that petitioners and respondents have consented to the filing of this brief. Petitioners' and respondents' letters of consent have been filed with the Clerk of the Court.

TBMA has worked with its member firms, Congress, the SEC, the Federal Reserve Board and the Federal Reserve Bank of New York, state regulators, and self-regulatory organizations to foster effective, efficient regulation; to enhance the liquidity and efficiency of the fixed income markets; to encourage sound credit and business practices for participants in such markets; and to promote the highest levels of professional standards and conduct in such markets. (More information about TBMA is available at www.bondmarkets.com.)

The issue raised by this case—the proper test for establishing loss causation in securities fraud cases—is one of great import to the securities industry and its investors. It is critically important to SIA and TBMA that member firms not be turned into guarantors that investments will be profitable where there is no causal connection between an alleged misrepresentation and a security's decline in price. *Amici* therefore have a vital interest in the issue presented in this case, and their views can assist the Court in resolving that issue.

INTRODUCTION

This case presents the question whether a plaintiff bringing a civil claim under section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and SEC Rule 10b-5 need only allege and show that he paid an inflated price for the security because of a misrepresentation, or must also allege and show that revelation of the misrepresentation caused a decline in price. Most courts that have addressed the question have adopted the latter rule, requiring a securities plaintiff to satisfy the element of loss causation by showing that the price of the security promptly declined when the allegedly concealed information was disclosed and limiting damages to

the amount of the decline.[2] But in the ruling below, the Ninth Circuit adopted the purchase-time inflation rule, requiring a plaintiff to plead and prove only that the price of a security was "inflated" when he bought shares.[3]

An illustration will demonstrate the vastly different outcomes under the conflicting approaches. Suppose plaintiff P buys $200 of stock in defendant D. As time passes, the value of P's investment declines to $20. *After* this decline, D announces the restatement of an accounting item. After this announcement, the value of P's shares remains at $20. P brings a lawsuit under Rule 10b-5. In the circuits applying the price-decline rule, the case is dismissed on a Rule 12(b)(6) motion because revelation of the alleged misrepresentation did not affect the market price. In contrast, under the Ninth Circuit's rule, P's lawyers bring a class action and hire an expert who opines on how much of the price P paid was "inflated" during the class period because of the undisclosed accounting issue. The case likely results in discovery, probably settlement, perhaps trial, and the prospect of a substantial award to P and P's lawyers—even though no causal link was ever established between any price decline and the alleged misrepresentation.

For the reasons set out below, the Ninth Circuit's rule of loss causation will create the wrong incentives for market participants and litigants, will expose securities issuers and market professionals to potentially devastating liability, and consequently will work substantial harm to the securities

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[2] *See Emergent Capital Inv. Mgmt., LLC* v. *Stonepath Group, Inc.*, 343 F.3d 189, 198-99 (2d Cir. 2003); *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 184-85 (3d Cir. 2000); *Bastian* v. *Petren Res. Corp.*, 892 F.2d 680, 684-85 (7th Cir. 1990); *First Interstate Bank of Nev., N.A.* v. *Chapman & Cutler*, 837 F.2d 775, 779-80 (7th Cir. 1988); *Robbins* v. *Koger Props., Inc.*, 116 F.3d 1441, 1447-49 (11th Cir. 1997).

[3] The Eighth Circuit follows the same rule. *See, e.g., Gebhardt* v. *ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

markets and to the economy. By contrast, the majority rule applied in most other circuits accords with the language of the Exchange Act and with long-established federal policy, and will provide the correct incentives for investors and other market participants.

SUMMARY OF ARGUMENT

The loss causation rule adopted by the Ninth Circuit is wrong and should be rejected for three related reasons.

First, contrary to an argument frequently made by securities plaintiffs, the Ninth Circuit's loss causation rule is not supported by *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988) (plurality opinion), or the efficient markets hypothesis used in *Basic*. To the contrary, that hypothesis holds that new material public information about a traded security is quickly reflected in its market price. Therefore, in any case to which the efficient markets hypothesis applies, a 10b-5 plaintiff must show the market price's prompt, negative response to disclosure of the alleged misrepresentation, and isolate that response from the market's responses to countless other pieces of information about the security. Under the Ninth Circuit's rule, however, showing the market's actual response to disclosure of the alleged misrepresentation is unnecessary, leaving no objective way to identify the price effect (if any) of the misrepresentation. The measure of damages, therefore, is dependent upon the subjective opinion of a retained expert.

Second, the Ninth Circuit's approach to loss causation is inconsistent with the plain language of the Exchange Act. The Exchange Act has always expressly limited recovery in private securities actions to investors' *actual* damages traceable to the defendants' misrepresentations. The Ninth Circuit's loss causation rule circumvents that limitation by allowing recovery for investment losses that cannot be objectively tied to the defendants' conduct. Furthermore, three provisions enacted in the Private Securities Litigation

Reform Act of 1995 ("PSLRA") confirm that Congress understands "loss causation" to mean "the *depreciation* in value of the subject security" caused by the defendant's specific misstatement or omission. 15 U.S.C. § 77*l*(b)[4]; see also *id.* § 78u-4(b)(4) (requiring securities plaintiff to prove that the defendant's misrepresentation or omission "caused the loss"); *id.* § 78u-4(e) (limiting recovery under section 10(b) to the investor's loss in the period following disclosure of "the misstatement or omission that is the basis for the action").

Third, the Ninth Circuit's approach promises serious harm to the securities industry and the economy. By exposing securities issuers and market professionals to ill-defined but substantial liability every time the markets decline, the Ninth Circuit's rule tends to create a disincentive for issuers, underwriters, and others to undertake or participate in securities transactions. Worse, the rule distorts the incentives necessary to the proper functioning of the markets by turning defendants into virtual guarantors of unprofitable investments, upsetting the markets' natural risk-reward balance and encouraging overly risky investor behavior.

ARGUMENT

Plaintiffs commonly argue that the fraud-on-the-market presumption used in *Basic* also justifies a corresponding approach to loss causation—that the presumption of *reliance* (or transaction causation) used in *Basic* should be construed as a presumption of legally compensable loss. That argument is fundamentally wrong. Not only does *Basic* not support a presumption of loss causation, but the language of the Exchange Act and the logic of *Basic* affirmatively disallow it. Transaction causation and loss causation are separate elements of private securities actions (a longstanding distinction recently made explicit by Congress), and both the

[4] Unless otherwise noted, emphases in quoted passages are added.

language of the statute and the logic of *Basic* rebut any suggestion that the presumption of reliance discharges a plaintiff's burden to plead and prove loss causation.

To the contrary, both *Basic* and the statutory language compel an approach to loss causation that turns on discrete, objectively observable market price responses to new, concrete pieces of material information. That approach, moreover, is consistent with the goals of the private securities laws, and it fosters the incentives needed to keep the financial markets healthy and strong.

I. THE NINTH CIRCUIT'S LOSS CAUSATION RULE IS INCONSISTENT WITH THIS COURT'S DECISION IN *BASIC* AND WITH THE EFFICIENT MARKETS HYPOTHESIS.

a. Securities class action plaintiffs routinely argue that the logic of *Basic* v. *Levinson*, 485 U.S. 224 (1988), supports a rule that an allegation of price inflation is a sufficient allegation of loss causation. See, *e.g.*, *In re Merrill Lynch & Co. Research Reports Secs. Litig.*, 273 F. Supp. 2d 351, 365-67 (S.D.N.Y. 2003) (rejecting that argument). The fraud-on-the-market presumption created for certain cases by *Basic*, however, only supports a presumption of reliance (also called transaction causation), not of loss causation. Any argument that *Basic* supported a presumption of loss causation was ended in 1995, when Congress amended the Exchange Act to provide expressly that a Section 10(b) "plaintiff shall have the *burden of proving* that the act or omission of the defendant alleged to violate the chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). Moreover, the logic of *Basic* itself supports a loss causation rule requiring that a plaintiff allege (and later prove) that a decline in price was caused by disclosure of previously concealed information.

Under *Basic*, most private securities litigation under Rule 10b-5 (including this case) is based on an allegation that the

securities traded in an efficient market. In a case based on such an allegation, the "premise [is] that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." 485 U.S. at 246. The guiding assumption is that an efficient market promptly and fully values all material public information (true and false) about the issuer of a traded security, and the market price on a given day reflects that composite valuation in real time. See, *e.g.*, R. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 Wm. & Mary L. Rev. 373, 374-75 (1984) (the hypothesis "posits that the price of a security reflects all publicly available information about a firm, and that prices react *almost instantaneously* and in an unbiased manner to any new information"), *cited in Basic*, 485 U.S. at 246 n.24.

The premise that securities markets react promptly to material information is central to the efficient markets hypothesis. Efficient markets by definition "are those in which information important to reasonable investors . . . is *immediately incorporated* into stock prices." *In re Burlington Coat Factory Secs. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997). Accordingly, "when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period *immediately following disclosure*, of the price of the firm's stock." *Oran* v. *Stafford*, 226 F.3d 275, 282 (3d Cir. 2000). Accord M. Mitchell & J. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 Bus. Law. 545, 558 (1994) ("the efficient markets hypothesis, supported by considerable empirical evidence, suggests that stock prices react *quickly* to the release of new information").[5]

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[5] Consequently, the efficient markets hypothesis may not necessarily apply to many debt securities, which trade much less frequently than, for example, stocks traded on the New York Stock Exchange.

Thus, in a case where the efficient markets hypothesis applies, a plaintiff cannot claim a compensable loss resulting from a misrepresentation without alleging and proving how the market promptly reacted after the alleged falsehood was revealed. The price of a security at the time of a purchase cannot by itself indicate how much value (if any) the market placed on an alleged but still unrevealed misrepresentation or omission, as opposed to other known factors about the company, much less general market or industry factors. It is only when a prior misrepresentation or omission is disclosed that the market's price can possibly give any indication as to the value of that particular piece of information. By definition, a price decline that occurred before such a disclosure cannot have been caused by that disclosure and cannot measure the value of information withheld prior to the disclosure. Such a pre-disclosure decline has to have been caused by—and reflect—other company, industry, and market factors.

Similarly, when a misrepresentation or omission is exposed, if the security's price does not promptly decline, there is no basis for alleging that the misrepresentation or omission caused a loss. The very efficient market on which the plaintiff premises his or her case has said otherwise. Indeed, when there is no negative market reaction to a disclosure, this indicates that if any inflation in the price of that security ever existed, it had other causes.

Finally, even if there is a post-disclosure decline, no loss has been caused if the investor sold the security prior to the disclosure. An "overpayment" can cause no economic injury if the buyer recoups the overage on the resale. This is common sense. If a purchaser buys a house during a "housing bubble" but sells before the bubble bursts, nobody would say that purchaser suffered a loss because he or she paid an inflated purchase price.

The Ninth Circuit's loss causation rule, though, does not require an allegation (or, later, proof) of a negative market

price reaction to the disclosure of a misrepresentation or omission, and is for that reason fundamentally inconsistent with the efficient markets hypothesis. Because the Ninth Circuit's approach focuses on the beginning of the transaction, without requiring consideration of how the transaction played out, it allows recovery where none is warranted—*e.g.*, where the plaintiff sold before the misrepresentation was exposed, or the misrepresentation was never exposed at all, or it was exposed but the market did not respond negatively.

By contrast, the majority loss causation rule (applied in the Second, Third, Seventh, and Eleventh Circuits) is the only rule consistent with an allegation of an efficient market, because it requires plaintiffs to trace their investment losses directly to specific market price reactions. In keeping with the controlling premise that efficient markets promptly and accurately value all material information, the majority rule allows recovery only when a plaintiff can establish a distinct price decline promptly following disclosure of an actionable misrepresentation or omission. The Ninth Circuit's rule imposes no such requirement and therefore is irremediably at odds with the ruling in *Basic*.

b. The fundamental unsoundness of the Ninth Circuit's approach is underscored by the difficult problems of proof it creates, which threaten unwarranted awards of indeterminate and potentially massive damages.

To show loss causation consistently with an efficient market allegation, a 10b-5 plaintiff should be required to allege and then demonstrate prompt, negative price movements caused by disclosure of the defendants' specific misrepresentations and segregate them from price movements caused by innumerable unrelated factors. If a case is properly based on the efficient markets hypothesis, and a proper allegation of a post-disclosure decline is made, the proof could be provided through a proper event study. An event study is "a statistical regression analysis that examines the

effect of an event, such as an allegedly fraudulent statement or omission, on a dependent variable, such as a company's stock price." *In re World Access, Inc. Secs. Litig.*, 310 F. Supp. 2d 1281, 1298 n.10 (N.D. Ga. 2004). A proper event study must isolate an efficient market's prompt reaction to a specific event by controlling for other events, filtering out general market "noise," and gauging the statistical significance of the market's reaction to the event in question. Thus, a proper event study is one that is projected over a short time period with clear benchmarks at the beginning and end of the interval in question. See generally Mitchell & Netter, *supra*, at 557-60.[6] When properly done, event studies can provide an objective, market-based check against speculative "expert" damages testimony. *Id.* at 584; see *World Access*, 310 F. Supp. 2d at 1298 n.10; *In re Imperial Credit Indus., Inc. Secs. Litig.*, 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003).[7]

[6] *Accord Fetch* v. *Northern Telecom Ltd. (In re Northern Telecom Ltd. Secs. Litig.)*, 116 F. Supp. 2d 446, 460 (S.D.N.Y. 2000) (holding expert testimony "fatally deficient in that [the plaintiffs' expert] did not perform an event study or similar analysis to remove the effects on stock price of market and industry information"); *In re Executive Telecard, Ltd. Secs. Litig.*, 979 F. Supp. 1021, 1025 (S.D.N.Y. 1997) ("The reliability of the Expert Witness' proposed testimony is called into question by his failure to indicate . . . whether he conducted an 'event study' to determine whether EXTL's stock price was affected by company specific factors exclusive of the challenged fraud."); *In re Oracle Secs. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993) ("Use of an event study or similar analysis is necessary more accurately to isolate the influences of information specific to Oracle which defendants allegedly have distorted . . . As a result of his failure to employ such a study, the results reached by [the plaintiffs' damages expert] cannot be evaluated by standard measures of statistical significance.").

[7] Of course, given the defining premise that an efficient market reacts *promptly* to material public information, *see supra* at 8-9, the proper use of an event study presupposes a discrete, identified disclosure of material information and a relatively short "event window" (the period for measuring the market's reaction to the disclosure). Because prices in an efficient market "react quickly to the release of new information," event windows ordinarily are short, "sometimes as short as one trading day"; "long event windows may include noise and information from other events, making it difficult to isolate the impact of the relevant event." Mitchell & Netter, *supra*, at 558. "The shorter the interval over which the calculation is performed, the greater our ability to match particular pieces of news with the effects attributable to them." F. Easterbrook & D. Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611, 628 (1985). If, on the other hand, the plaintiff is unable to cite a specific disclosure, or relies on an unacceptably extended period of market "reaction," an event study loses its evidentiary efficacy: "the longer the potential period of adjustment, the more likely it is that noise and the presence of other information will render the calculations imprecise and perhaps unusable." D. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 Nw. U. L. Rev. 135, 177-78 (2002); *cf. Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156, 171 (2d Cir. 1980) (observing the difficulty of measuring a market's reaction to information in the absence of "a sharp change in market price over a short period"; a longer period or an especially "noisy" market tends to make the reaction to the alleged misrepresentation "impossible as a practical matter to isolate").

But the Ninth Circuit's approach, which ignores the market price's reaction, requires no objective check on expert speculation about damages. If a plaintiff need only allege purchase-time inflation, and need not allege (or show) any discount in the market price when the truth came out, then the one objective gauge of the plaintiff's compensable losses has been taken out of the equation. See *First Nationwide Bank* v. *Gelt Funding Corp.*, 27 F.3d 763, 770 (2d Cir. 1994) ("The key reasons for requiring direct causation include avoiding unworkable difficulties in ascertaining what amount of the plaintiff's injury was caused by the defendant's wrongful action as opposed to other external factors, and in apportioning damages between causes."). Instead, a plaintiff will merely assert that the security was overpriced when he bought it and offer subjective opinion testimony as to what degree of inflation the jury should attribute to the defendants' alleged misrepresentations.

Without an identifiable link to discrete, prompt market reactions, there is no way objectively to separate the effect (if any) of the claimed misrepresentation from the effects of the countless other forces operating on the security's price—including both general market movements and unrelated wrongdoing (*e.g.*, fraud by another defendant). Rather than demonstrating the *actual* impact of a misrepresentation on the security's market price, the plaintiff's expert will simply state what he thinks would have been a fair price. Rather than showing how the market *did* react to the disclosure of a specific misrepresentation, the witness will opine that it *would have* reacted in a certain way under other conditions. Thus, all manner of unactionable investor losses can be stuffed into the 10b-5 damages basket.

Indeed, the Ninth Circuit's rule allows a potential recovery even where the claimed falsehood was disclosed *after* a large decline in the price of a security and where the disclosure did *not* prompt any further decline. In such a case the plaintiff's expert often gives a two-part opinion: (1) the pre-disclosure decline measures generically the market's coming to understand that the company had poor business prospects; and (2) the information disclosed *after* the actual decline also "would have" caused a similar hypothetical decline if the security had not already declined. Because the market had no negative reaction to the actual disclosure, however, there is no objective check on such junk economics. Nor can there be any objective check if a plaintiff's expert can assert causation by claiming that earlier disclosure of a relatively inconsequential fact "would have" triggered a series of events that ultimately "would have" led to other, more important disclosures. See *Robbins* v. *Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997). But the Ninth Circuit's loss causation rule invites just such expert speculation. Thus, its approach improperly allows the prospect of massive damages to be leveraged out of almost any minor misstatement. Cf. *Holmes* v. *Securities Investor Prot. Corp.*, 503 U.S. 258, 287

(1992) (Scalia, J., concurring in the judgment) ("Life is too short to pursue every human act to its most remote consequences; 'for want of a nail, a kingdom was lost' is a commentary on fate, not the statement of a major cause of action against a blacksmith.").

This kind of expert razzle-dazzle has no place in securities litigation based on the efficient markets hypothesis.[8] Yet the Ninth Circuit's loss causation rule invites it by allowing recovery that contradicts or ignores the market price's actual reaction to disclosure of the specific misrepresented fact. By contrast, the majority loss causation rule requires objectively verifiable evidence and a tight fit between disclosure of a misrepresentation and an attendant price decline. That is the correct rule, and this Court should expressly adopt it.

II. THE NINTH CIRCUIT'S LOSS CAUSATION RULE IS INCONSISTENT WITH THE STATUTORY LANGUAGE.

The requirement that a plaintiff demonstrate a prompt negative market reaction to the revelation of the defendant's alleged misconduct is not only supported by the premise of *Basic*, it is compelled by the language of the Exchange Act itself, and its companion, the Securities Act of 1933. Because the loss causation rule adopted by the Ninth Circuit is inconsistent with that language, it should be rejected.

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[8] *See, e.g.*, *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 187-91 (3d Cir. 2001) (plaintiffs cannot "gloss over" the loss causation requirement by having an expert offer some speculative "formulaic nostrum"); *West* v. *Prudential Sec., Inc.*, 282 F.3d 935, 938 (7th Cir. 2002) (requiring trial courts in 10(b) cases to "face[] and squarely decide[]" even "[t]ough questions" concerning reliability of expert theories of causation, "if necessary by holding evidentiary hearings and choosing between competing perspectives"; plaintiffs do not satisfy the causation requirement "just by hiring a competent expert"); *Grandon* v. *Merrill Lynch & Co.*, No. 95 Civ. 10742(SWK), 2003 WL 22118979, at *6 (S.D.N.Y. Sept. 11, 2003).

a. Ever since Congress enacted the Exchange Act in 1934, damages in private securities actions have been expressly limited to investors' *actual* losses. The measure of damages in 10b-5 cases is dictated by section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a), which expressly limits recovery to "actual damages," meaning the plaintiff's actual monetary loss. See *Randall* v. *Loftsgaarden*, 478 U.S. 647, 662-63 (1986); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 154-55 (1972). This limitation means that private securities actions are not a vehicle for imposing punitive damages or otherwise punishing defendants. See *Boguslavsky* v. *Kaplan*, 159 F.3d 715, 721 (2d Cir. 1998) ("punitive damages are unavailable under the 1934 Act"); *Cyrak* v. *Lemon*, 919 F.2d 320, 326 (5th Cir. 1990) ("Punitive damages are not recoverable in a 10b-5 action."); *Pelletier* v. *Stuart-James Co.*, 863 F.2d 1550, 1557 (11th Cir. 1989) ("'Actual damages' has been interpreted to mean some form of economic loss and does not include punitive damages."). Congress reinforced this in 1995 by enacting a provision in the PSLRA amending RICO to provide that "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of [RICO]." Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 107, 109 Stat. 737, 758 (amending 18 U.S.C. § 1964(c)). This exclusion makes clear that private securities plaintiffs are not eligible for RICO's treble damages.

The "actual damages" limitation is consistent with the majority loss causation rule and inconsistent with the Ninth Circuit's purchase-time inflation rule. Under the Ninth Circuit's rule, damages are divorced from investors' actual losses for two reasons. First, defendants can be held potentially liable not only to those investors who can prove a price decline caused by the defendants' conduct, but also to investors who did not lose money as a result of the defendants' conduct, for example, because they sold before the conduct was exposed and the price dropped. Thus, a

securities issuer may be held liable for many times the losses actually occasioned by its misstatement or omission—that is, for what are really punitive not "actual" damages. Second, as discussed above, damages that are not linked to actual, prompt price changes in the market, but instead to dueling expert witnesses' subjective opinions, bear no relationship to a plaintiff's actual losses and, moreover, are uncertain and potentially enormous.

The majority loss causation rule, by contrast, is fully consistent with the statute's "actual damages" requirement. That rule makes damages available only to plaintiffs who can show that the losses they suffered were caused by specific misrepresentations made by the defendant, as demonstrated by a prompt and distinct market price adjustment upon disclosure of the specific, correct information. When price declines have other causes, such as publicly available information about other, nonfraudulent facts about the company, the industry, or the general market, such declines are not "actual damages" caused by the defendant.

b. Any doubt as to whether the Ninth Circuit's loss causation rule conflicts with the Exchange Act was resolved by the PSLRA. In the PSLRA, Congress codified the loss causation requirement by providing that in a private section 10(b) case, the "plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused *the loss* for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). This language simply does not allow, for example, a plaintiff to measure damages by a price decline that occurred *before* any misrepresentation was disclosed to the market. A disclosure cannot have caused a decline that already occurred.

Moreover, in another provision of the federal securities statutes, Congress defined the "loss" in loss causation as a decline, not inflation. Section 12 of the Securities Act of 1933 (15 U.S.C. § 77*l*) creates an express cause of action in certain circumstances. Section 105 of the PSLRA defines

"Loss Causation" in a section 12(a)(2) civil action. See Pub. L. No. 104-67, § 105, 109 Stat. at 757; 15 U.S.C. § 77*l*(b). Section 105 defines the actionable loss as "*the depreciation in value* of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein." *Id.*; see also S. Rep. No. 104-98, at 7 (1995) (describing loss causation under 15 U.S.C. § 78u-4(B)(4) as "the loss in the value of their stock . . . caused by the Section 10(b) violation and not by other factors"). Plainly, "depreciation in value" means decline in price, not inflation. Section 105 is highly significant because this Court has held that it would be "anomalous to impute to Congress an intention in effect to expand [aspects of] 10b-5 actions beyond the bounds delineated for comparable express causes of action." See *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180 (1994).

Congress also implicitly endorsed the majority loss causation rule requiring a corrective disclosure and accompanying price drop in another PSLRA provision. The statute's "lookback" provision (section 21D(e) of the Exchange Act) limits a securities plaintiff's damages to "the difference between the purchase or sale price . . . and the mean trading price of that security during the 90-day period *beginning* on the date on which *the information correcting the misstatement or omission that is the basis for the action is disseminated to the market*." 15 U.S.C. § 78u-4(e).

This provision is significant not only because it reflects Congress's concern with "windfall" damages for price movements "unrelated to the alleged fraud," S. Rep. No. 104-98, at 20, but also because it uses the price of the security "*beginning*" with "*information correcting the misstatement or omission*" to measure a plaintiff's damages. 15 U.S.C. § 78u-4(e). The 90-day window is pegged to the date of disclosure because Congress expressly recognized that an investor's

damages are limited by "the difference between the price he or she paid for the security and the price of the security on *the date the corrective information is disseminated to the market*." S. Rep. No. 104-98, at 19-20.

The Ninth Circuit's loss causation rule is completely at odds with this damages-limitation provision because it ignores the market's reaction to "the information correcting the misstatement or omission." Indeed, it is not clear how the PSLRA's damages limitation could even be applied under the Ninth Circuit's rule, since that rule does not require the plaintiff to allege or prove the effect on the market price of a corrective disclosure. In short, a loss causation rule that merely requires price inflation at the time of purchase is flatly inconsistent with Congress's expressed intent in enacting the Exchange Act, as modified by the PSLRA.[9]

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[9] As we have shown, Congress has itself defined loss causation as requiring that a specific misrepresentation cause a specific price decline. Accordingly, there is no reason to look to the common law to fill any statutory gap. Nevertheless, under established tort principles that exist apart from the Exchange Act, there is no recovery when a price decline is caused by other factors. *See, e.g.*, W. P. Keeton et al., *Prosser and Keeton on the Law of Torts* § 110, at 767 (5th ed. 1984) ("if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors in no way relate[d] to the representations will not afford any basis for recovery"). The *Restatement (Second) of Torts* provides a useful illustration:

> A, seeking to sell to B the municipal bonds of C County, fraudulently tells B that the county has received full payment for the bond issue. B purchases the bonds in reliance upon this statement. Subsequently the county is paid in full, but the bonds are held void by the supreme court of the state on the ground that a court had no jurisdiction to issue certain orders with respect to them. As a result B suffers pecuniary loss. A is not liable to B for the loss.

Restatement (Second) of Torts § 548A cmt. b, illus. 1 (1977). In this example, the plaintiff will not recover because his loss on the bond investment was not caused by the defendant's misrepresentation—*even though* the plaintiff's purchase price was inflated because of the misrepresentation about the county's receipt of full payment—because the

III. THE NINTH CIRCUIT'S LOSS CAUSATION RULE WOULD HAVE SERIOUS HARMFUL EFFECTS.

The Ninth Circuit's misguided loss causation rule, if allowed to stand, will seriously damage the securities industry and securities markets in three significant ways.

First, the Ninth Circuit's rule will tend to discourage market participants (including securities issuers, investment firms, lawyers, and accountants) from undertaking or participating in economically beneficial market transactions. As shown above, the Ninth Circuit's rule permits recovery by investors with no actual losses, and invites gross over-recovery even in cases with some merit. The rule thus exposes market participants to potentially massive liability for losses untied to their conduct.

The inevitable consequence is a disincentive for those market participants to undertake or participate in securities transactions. Investment banks, for example, will inevitably tighten their purse strings and decline certain otherwise attractive transactions if faced with the prospect of having to underwrite a market slump. The resulting suppression of a robust securities market harms the entire economy. See H.R. Rep. No. 104-50, at 20 (1995) ("Fear of litigation keeps companies out of the capital markets" and "businesses suffer as auditors and directors decline engagements and board positions."); cf. *Bastian* v. *Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990) ("No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation.").

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investment had a different, unrelated cause of loss (*i.e.*, with or without full payment, the bonds were void). Yet the Ninth Circuit's approach would allow recovery in such circumstances based solely on price inflation at the time of purchase.

Second, the Ninth Circuit's rule interferes with the proper functioning of modern financial markets. Every investor has a panoply of investment options, ranging from federally insured certificates of deposit ("CDs") that have essentially zero default risk but a limited return, to Dow 30 stocks that traditionally offer moderate risk and a solid return, to stock in smaller and less well-established companies that traditionally have substantial risk but offer higher potential returns. With respect to federally insured CDs, Congress has chosen to socialize investment losses by implementing an insurance system administered by the FDIC and other agencies. Returns are modest but assured, and insured depositors have essentially no incentive to determine which insured banks are likely to become insolvent.[10]

In contrast, with respect to the stock and bond markets, Congress has chosen not to create investor insurance. See *Carlton* v. *Franklin*, 911 F.2d 721 (4th Cir. 1990) (per curiam) (table), *available at* 1990 WL 116788, at *4 ("The reasoning behind the requirement of loss causation is that, otherwise, the federal securities laws would establish an

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[10] As Federal Reserve Board Chairman Alan Greenspan recently testified:

> The benefits of deposit insurance, as significant as they are, have not come without a cost. The very process that has ended deposit runs has made insured depositors largely indifferent to the risks taken by their depository institutions, just as it did with depositors in the 1980s with regard to insolvent, risky thrift institutions. The result has been a weakening of the market discipline that insured depositors would otherwise have imposed on institutions. Relieved of that discipline, depositories naturally feel less cautious about taking on more risk than they would otherwise assume. No other type of private financial institution is able to attract funds from the public without regard to the risks it takes with its creditors' resources. This incentive to take excessive risks at the expense of the insurer, and potentially the taxpayer, is the so-called moral hazard problem of deposit insurance.

Alan Greenspan, Chairman, Fed. Reserve Bd., Testimony on Deposit Ins. Before the Senate Comm. on Banking, Housing, and Urban Affairs (Feb. 26, 2003), *available at* http://www.federalreserve.gov/boarddocs/testmony/2003/20030226/default.htm.

insurance program for every security purchased in reliance on a misstatement, even if the misstatement bears no relation to the reason for the decline in the security's value."); *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) ("Absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission."), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983). As a result, investors have every incentive to investigate and identify which potential high-return investments are sound and which are not. Thus, unlike in a system with investor insurance, the market dynamics of risk and reward give investors a full incentive to direct capital to uses where the potential rewards genuinely justify the potential risks.

The Ninth Circuit's loss causation rule skews this risk-reward dynamic by changing the market dynamics for higher-risk investments. By definition, insurance against the negative consequences of a risky activity encourages the insured to engage in that activity. See *May Dep't Stores Co.* v. *Federal Ins. Co.*, 305 F.3d 597, 601 (7th Cir. 2002) (noting "the incentive that insurance can give an insured to increase the risky behavior covered by the insurance"). By allowing 10b-5 actions to serve as a vehicle for recovery of investment losses that are *not* attributable to a securities defendant's behavior, the Ninth Circuit's rule would give investors greater incentive to invest in riskier ventures. If a higher-risk company pays off, the investors keep the profits; if it fails, the defendants bear the burden of much of the loss. *Bastian*, 892 F.2d at 685 ("Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities"). This would short-circuit the beneficent risk-reward dynamic of the securities markets. At a minimum, whether to change the existing securities system to require investor insurance is a matter for Congress, not the courts.

Third, the Ninth Circuit's rule harms shareholders by fostering arbitrary settlements and awards that fail to align litigation recoveries with investors' interests. In the real-world context of private securities litigation, "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general"; in 10b-5 cases "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739-40 (1975).

> This uncertainty and excessive litigation can have ripple effects. For example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and *in turn incurred by the company's investors*, the intended beneficiaries of the statute.

Central Bank, 511 U.S. at 189.

Congress recognized the same phenomenon, and designed the PSLRA with it in mind. "If a defendant cannot win an early dismissal of the case, the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial." S. Rep. No. 104-98, at 7 (1995) (internal quotation marks omitted). That is, large settlements are almost assured to a 10b-5 plaintiff class that survives dispositive motions, and the settlement usually has little to do with the merits of the lawsuit.

At least one major empirical study bears this out, concluding that "there appears to be *no appreciable risk* of non-recovery" in securities class actions, because "virtually all cases are settled," regardless of their legal merits. J. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 578 (1991).[11] For various familiar reasons, including risk aversion, asymmetric litigation costs, and the ubiquity of D&O insurance, the pressure to settle a securities suit—even a meritless one—is as a practical matter all but irresistible. *Id.* at 521-55. Accordingly, "when there has been a sharp decline in the market price of a company's stock, the mere filing of a complaint appears to be a ticket to a guaranteed and substantial recovery. *Getting the claim into the legal system*, without more, sets in motion forces that ultimately compel a multi-million dollar payment." *Id.* at 569. Accord *Hevesi* v. *Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004) ("numerous courts and scholars have warned that settlements in large [securities] class actions can be divorced from the parties' underlying legal positions"); *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001) (discussing the "inordinate or hydraulic pressure on [securities fraud] defendants to settle, avoiding the risk, however small, of potentially ruinous liability").

The Ninth Circuit's loss causation rule invites such settlements because it fails to eliminate the claims of uninjured investors at the pleading stage and affords no

[11] As the Second Circuit has observed,

> [a]necdotal evidence tends to confirm [Alexander's] conclusion. Indeed, [Melvyn I.] Weiss and his partner William S. Lerach of the Milberg firm have stated that losses in these cases are "few and far between," and that they achieve "a significant settlement although not always a big legal fee, in 90% of the cases [they] file."

Goldberger v. *Integrated Res., Inc.*, 209 F.3d 43, 52 (2d Cir. 2000) (quoting *In re Quantum Health Res., Inc. Secs. Litig.*, 962 F. Supp. 1254, 1258 (C.D. Cal. 1997)).

objective check on causation and damages. Given the high strike value of 10b-5 class suits, the practical result is a wealth transfer from a company's current securities holders to a group of investors who bought during the class period—many of them no longer investors in the company—and their lawyers.

By contrast, the majority loss causation rule, which turns on observable market movements, supplies a ready means for weeding out unmeritorious claims through motions practice. For claims that can survive a motion to dismiss and a motion for summary judgment, settlement discussions can be based on objective events and established methodologies such as proper event studies, rather than on wholly subjective "expert" speculation. For this reason, in addition to its consistency with Congressional policy and legal precedent, the majority rule is the correct one.[12]

[12] Any concern about defendants' escaping the consequences of their wrongdoing is entirely misplaced. Not only does the majority loss-causation rule allow full recovery of actual losses, but it in no way detracts from federal and state administrative and criminal remedies that are otherwise available against wrongdoers even when there is no financial loss. Recent history shows these are powerful tools.

CONCLUSION

For the foregoing reasons, the Ninth Circuit's ruling should be reversed.

Respectfully submitted,

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Petitioners,

v.

MICHAEL BROUDO, *et al.*,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

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INTEREST OF THE *AMICUS CURIAE*[1]

Technology Network ("TechNet") is a network of Chief Executive Officers and senior partners of more than 150 companies in the information technology, biotechnology, venture capital, investment banking and legal industries. The association is organized to promote the growth of the technology industry and the economy by building long-term relationships among technology leaders. The majority of TechNet's members lead companies capitalized through publicly traded shares on the Nation's major stock exchanges. As members and investors in the technology and biotechnology industries, TechNet's members represent the leading edge of developing, manufacturing, and marketing emerging technologies.

The question presented by this case – the proper standard for pleading and proving "loss causation" in securities fraud cases – is an issue of recurring importance for members and investors in the emerging technology industries. Companies in these industries rely heavily on public capital investments to develop new ideas, many of which may never become viable in the marketplace. These companies' stock prices are often highly volatile, as the market potential of their emerging technologies waxes and wanes.

Due to the volatility of their stock, technology companies are frequent targets of private securities litigation,

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[1] Pursuant to this Court's Rule 37.6, *amicus* TechNet states that no counsel for any party authored this brief in whole or in part, and no person or entity made a monetary contribution to the preparation or submission of the brief. Pursuant to Rule 37.3(a), TechNet received permission to file this brief from both parties to this matter. A copy of each party's notice of consent is on file with the Clerk of the Court.

and such litigation is therefore of special concern. Congress recognized this concern when it enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA")[2] to combat the high cost of frivolous securities litigation. 141 CONG. REC. H2763 (1995) (statement of Rep. Cox) ("High-tech and biotech companies have paid 40 percent of the costs of strike suit settlements[.]"). This concern remains unabated; even after Congress passed the PSLRA, companies in the technology industries remain the target of over 40% of all private securities litigation. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003:4 U. ILL. L. REV. 913, 959. Because of the vital concern its members have for the issue presented in this matter, TechNet files this *amicus curiae* brief in support of Petitioners.

INTRODUCTION

The Ninth Circuit ruled in this case that plaintiffs in private securities litigation meet the standard for pleading loss causation by alleging that the price of the stock at issue was inflated on the date of purchase. This ruling improperly limits the ability of the district courts to weed out strike suits in which plaintiffs cannot plead a causal link between an alleged fraud and a decline in the price of the stock. As a result, the ruling subjects technology and other companies whose stock prices are inherently volatile to the burden and expense of unmeritorious litigation,

[2] Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995).

and, by so doing, contravenes the expressed intent of Congress in enacting the PSLRA.

REASONS FOR OVERTURNING THE RULING

1. THE NINTH CIRCUIT'S STANDARD FOR PLEADING LOSS CAUSATION UNDULY CURTAILS THE DISTRICT COURTS' ABILITY TO DISMISS UNMERITORIOUS CASES

The PSLRA confirms that loss causation is a required element of a claim for securities fraud. *See* 15 U.S.C. § 78u-4(b)(4). As courts, including the Ninth Circuit, have made clear, two types of causation are required for such claims: "transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused the harm." *Binder v. Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999) (quoting *McGonigle v. Combs*, 968 F.2d 810, 820 (9th Cir. 1992)); *see also, e.g., Emergent Capital Inv. Mgt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 196-97 (2d Cir. 2003); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1446, 1447 (11th Cir. 1997).

As the Ninth Circuit itself has acknowledged, "the loss causation requirement limits the ability of plaintiffs to recover for losses sustained on the basis of factors unrelated to any misrepresentation or fraud." *Ambassador Hotel Co. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1027 (9th Cir. 1999). Other courts concur. *See, e.g., Emergent Capital*, 343 F.3d at 197 ("[I]f the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation will not have been established."); *Gasner v. Bd. of Supervisors*, 103 F.3d 351, 360 (4th Cir.

1996) (loss causation not established where intervening causes, as opposed to misrepresentation, resulted in failure of venture); *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990) (loss causation not established where the plaintiffs' investments declined due to a general decline in industry, rather than as a result of the alleged fraud).

In the Ninth Circuit, however, this limitation is effectively waived at the pleading stage in fraud on the market cases. According to the Ninth Circuit, plaintiffs adequately plead loss causation simply by alleging that "the price *on the date of purchase* was inflated because of the misrepresentation." *Broudo v. Dura Pharms.*, 339 F.3d 933, 938 (9th Cir. 2003) (emphasis in original). This holding conflicts with those of other circuits, which require a plaintiff to plead and prove a causal connection between the alleged fraud and a decline in the price of the stock. *See Emergent Capital*, 343 F.3d at 197 (requiring allegation connecting the alleged misrepresentations or omissions to the decline in stock price); *accord Semerenko v. Cendant Corp.*, 223 F.3d 165, 184-85 (3d Cir. 2000); *accord Robbins*, 116 F.3d at 1446, 1448-49; *accord Bastian*, 892 F.2d at 684-86.

By declining to require plaintiffs to plead the causal connection between the alleged fraud and a decline in the price of the stock, the Ninth Circuit unduly restricts the ability of the district courts to dismiss cases in which plaintiffs' losses were the result of factors other than fraud. If direct, intervening causes are eliminated from the loss causation analysis at the pleading stage – whether the intervening cause is an inherently volatile stock price, a catastrophic event that affects the overall economy, or even something more specific, like the introduction of a

competing product by another company – then there would remain no "cause" in loss causation. The Ninth Circuit itself has acknowledged that this cannot be the law: "[t]o prove loss causation, the plaintiff must demonstrate a causal connection between the deceptive acts that form the basis for the claim of securities fraud and the injury suffered by the plaintiff." *Ambassador Hotel*, 189 F.3d at 1027. Plaintiffs should be required to plead what they must prove. If they cannot so plead, then their claims should be dismissed.

2. THE NINTH CIRCUIT'S STANDARD FOR PLEADING LOSS CAUSATION UNDULY BURDENS TECHNOLOGY COMPANIES

The technology industry already faces a disproportionate amount of securities litigation – over 40% of all private securities class actions target technology companies. Perino, *supra*, at 959. The average public company faces a 9% probability over a five-year period that it will be named as a defendant in at least one securities class action lawsuit. *See* Elaine Buckberg et al., *Recent Trends in Securities Class Action Litigation*: 2003 UPDATE, BNA CLASS ACTION LITIGATION REPORT, VOL. 5, NO. 8, at 305 (April 23, 2004). Rates are substantially higher for high-technology companies. *See* PricewaterhouseCoopers, 2003 Securities Litigation Study, at 5 (August 2004), at http://www.10b5.com. In fact, private securities plaintiffs target technology companies two and a half times as often as companies in other industries. Perino, *supra*, at 961. In particular, companies in the computer services and pharmaceutical industries are at the highest risk for being sued for securities fraud. *See* PricewaterhouseCoopers, 2003 Securities Litigation Study, at 5.

The trigger for much of this litigation is a drop in the price of a company's stock. Indeed, a list of recently-filed securities class actions shows that most are filed against technology companies, that most allege violations of sections 10(b) and 20(a) and Rule 10b-5, and that most were filed quickly after a decline in stock price. *See* http://securities.stanford.edu/filings.html; *see also* Perino, *supra*, at 964 (over 50% of filings occur within three weeks of end of class period). However, stock prices for companies in the technology sector are inherently volatile. In this sector, dramatic stock price swings represent the norm rather than the exception, even in the absence of any fraud. *See* Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 777, 578-79 (2000). Technology "firms are engaged in highly competitive and dynamic industries in which products can lose their competitive advantage virtually overnight. . . . Consequently, the stock price of firms in these industries often is volatile and drops sharply because of announcements of unexpected bad news." Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 494 n.14 (1996). In the biotech industry, for example, "the fate of life sciences companies often hangs on the result of an FDA trial or scientific experiment. *See* William O. Fisher, *Key Disclosure Issues for Life Sciences Companies: FDA Product Approval, Clinical Test Results, and Government Inspections*, 8 MICH. TELECOMM. & TECH. L. REV. 115, 116 (2002).

By allowing plaintiffs who have suffered no cognizable damage to reach the discovery stage of litigation, the Ninth Circuit's pleading standard imposes substantial costs on a defendant. Regardless of a claim's merit, approximately

80% of the cost of securities litigation arises in discovery. Perino, *supra*, at 921 n.36. Such discovery costs typically approach, and can exceed, two million dollars. Joseph A. Grundfest, *Why Disimply*, 108 HARV. L. REV. 727, 742 (1994-95).

On top of the costs of discovery are the costs of settlement. Companies often calculate that settlement would be less expensive than the costs of protracted discovery; they therefore settle – not because of wrongdoing, but because of basic rational economics. James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 918-19 (1995-96).[3]

The majority pleading standard allows district courts to dismiss those strike suits in which plaintiffs cannot link a decline in a company's volatile stock price to any alleged fraud. By instead allowing such actions to survive a motion to dismiss, the Ninth Circuit's standard imposes an inappropriate burden on technology and other companies whose stock prices are inherently volatile.

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[3] As Professor Grundfest argues, a settlement below ten million dollars can indicate that the action was an unmeritorious strike suit. *Grundfest, supra*, at 743. Through 2003, the median settlement in securities cases was six million dollars. Laura E. Simmons & Ellen M. Ryan, *Post-Reform Act Securities Lawsuits*, CORNERSTONE RESEARCH at http://securities.stanford.edu/Settlements/REVIEW_1995-2003/2003_Settlements.pdf. Thus, by Professor Grundfest's measure, more than half of these settled cases may well have been frivolous.

3. THE NINTH CIRCUIT'S STANDARD FOR PLEADING LOSS CAUSATION CONFLICTS WITH THE EXPRESSED INTENT OF CONGRESS TO RESTRICT ABUSIVE CLASS ACTIONS

In enacting the PSLRA, Congress was particularly concerned with the burden and expense that abusive securities class actions impose on technology and other companies with volatile stock prices. *See Securities Litigation Reform Act – Veto, Hearing on H.R. 1058 before the Senate*, 141 CONG. REC. S19,146-47 (1995) (statement of Sen. D'Amato) (quoting editorial, WASHINGTON POST, Dec. 22, 1995 "This kind of suit has turned out to be a special danger to new companies, particularly high-technology ventures with volatile stock prices. The Country has a strong interest in encouraging these companies and shielding them from a style of legal assault that is not far from extortion."); SECURITIES LITIGATION REFORM, CONFERENCE REPORT, H.R. REP. 104-369 at 43 (1995) ("Technology companies – because of the volatility of their stock prices – are particularly vulnerable to securities fraud lawsuits[.]"); PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, REPORT OF THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, S. REP. NO. 104-98 at 5 (1995) ("Public companies – particularly high-tech, bio-tech and other growth companies . . . are sued disproportionately in 10b-5 litigation. . . ."); 141 CONG. REC. E184 (statement of Rep. Mineta introducing *The Securities Litigation Equity Act of 1995*) (1995) (litigation costs "result in less capital for the R&D investments U.S. high-tech companies use to maintain their position at the cutting edge of the world market. For these reasons, securities litigation reform is a top priority for our Nation's high technology community.").

The PSLRA addressed these concerns by specifically requiring plaintiffs in private securities class actions to *prove* that the alleged fraud caused the losses for which plaintiffs seek to recover damages. 15 U.S.C. § 78u-4(b)(4). The Ninth Circuit's relaxed standard for *pleading* that causal connection effectively frustrates Congress's clear intent to restrict private securities actions to those cases in which plaintiffs can establish a loss arising from alleged fraud rather than extraneous factors such as the volatility of a company's stock price.

This is not merely a Ninth Circuit issue; it is a national issue. As Congress recognized in passing the PSLRA, the technology sector is vital and, without scarring the national economy, cannot remain subject to assault or extortion in the form of frivolous securities litigation. *Securities Litigation Reform Act – Veto, Hearing on H.R. 1058 before the Senate*, 141 CONG. REC. S19,146-47 (1995) (statement of Sen. D'Amato); *see also* CONFERENCE REPORT, H.R. REP. 104-369 at 31-32, 43. The PSLRA balances the interests in compensating investors for actual damages caused by actual fraud against strike suits that deter investors from capitalizing one of the United States' most dynamic, and essential economic sectors. The Ninth Circuit's pleading standard upsets that balance and is therefore contrary to Congress' intent in passing the PSLRA.

CONCLUSION

For the foregoing reasons, district courts must have the power to dismiss actions where plaintiffs cannot plead a causal link between the price of the subject company's

stock and an alleged fraud. The Ninth Circuit's standard for pleading loss causation in private securities litigation unnecessarily hinders the district courts' ability to dismiss these lawsuits and should therefore be overturned.

Respectfully submitted,

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Petitioners,

v.

MICHAEL BROUDO, *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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BRIEF OF WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

INTEREST OF THE *AMICUS CURIAE*[1]

The Washington Legal Foundation ("WLF") is a national non-profit public interest law and policy center based in Washington, D.C., with supporters nationwide. WLF promotes legal reform in our civil justice system through publication on the topic by its Legal Studies Division. WLF also litigates cases and files *amicus curiae* briefs in this and other courts to oppose overreaching by courts that act contrary to the plain meaning of language chosen by Congress. WLF regularly opposes decisions that encourage the filing of abusive class actions in which the prospect of attorneys' fees being awarded to class action lawyers is paramount over the proper functioning of vital industries, such as the life sciences industry from which this case arises, the well-being of the nation's citizens and economy, absent class members, consumers and shareholders. The Ninth Circuit's decision is just such a decision.

For that reason, WLF will provide the Court with a broader public interest perspective in this case than that provided by the parties. WLF will focus on both the legal and policy reasons why the Ninth Circuit's decision, if permitted to stand, would threaten the life sciences industry, an industry that is vital to the well-being of our nation and its citizens.

[1] Letters from the parties consenting to the filing of this brief have been lodged with the Clerk of the Court. Pursuant to this Court's Rule 37.6, *amicus* states that no counsel for any party authored this brief, in whole or in part, and that no entity or person, aside from *amicus* and its counsel, made any monetary contribution to the preparation or submission of this brief.

INTRODUCTION

That Petitioner here is a life sciences company should not be surprising. Over recent years, securities class action lawyers have mounted an ever growing assault against the pharmaceutical and, particularly, biotechnology companies that make up the life sciences industry. The number of securities fraud class actions filed against life sciences companies has soared — from 2002 to 2003 these filings rose nearly 40%. And the percentage of overall securities fraud class actions that were filed against life sciences companies also soared — from 9% in 2002 to 15% in 2003. This is not mere chance. The life sciences industry is inherently risky and generates many more failed developmental efforts than successes, and at the announcement of such failures securities class action lawyers pounce.

This trend should be cause for serious alarm. Life sciences companies, as former FDA Commissioner Mark McClellan has said, "are not only achieving breakthroughs in the lab. They are making growing contributions to our economy, our homeland and national defense, and our public health — helping us live better lives than ever before."[2] The

[2] See FDA Commissioner Mark B. McClellan, Remarks before the Biotechnology Industry Organization (June 23, 2003), *available at* http://www.fda.gov/oc/speeches/2003/biotechnology0623.html. Acting FDA Commissioner Lester M. Crawford similarly said earlier this year that life sciences products — such as "biologics, drugs, foods, medical devices and veterinary medicines — are integral to public health as well as the fundamental economy upon which this great nation is based." Remarks at Newsmaker Luncheon (Aug. 2, 2004), *available at* http://www.fda.gov/oc/speeches/2004/newsmaker0802.html.

Congress also has acknowledged the vital importance of the industry. Most prominent among recent efforts to encourage life sciences companies to continue their important work is the passage of the Food and Drug Administration Modernization Act of 1997, at which time Congress recognized: "We are trying to take advantage of these marvelous technological breakthroughs in drugs and devices and products . . . and make

vital importance of the industry to our nation's well being is illustrated by the products being developed by life sciences companies that have been named in securities class actions. In the last year-and-a-half, class action lawyers have attacked companies attempting to develop products designed to treat cancer (Genta Inc.), pneumonia (Intrabiotics Pharmaceuticals, Inc.), skin disease (Vaso Active Pharmaceuticals, Inc.), infection (Vicuron Pharmaceuticals Incorporated), neurobehavioral problems in children (Noven Pharmaceuticals, Inc.), and HIV and hepatitis C (Vertex Pharmaceuticals Incorporated). Here, the Petitioner is being sued in connection with its attempt to develop a device to aid the treatment of asthma.

This brief focuses on the particular challenges that the life sciences industry faces from the threat posed by unrestrained filings of securities fraud class action lawsuits — a threat that will be exacerbated if the Ninth Circuit's decision in this case is not reversed.

BACKGROUND

A. The Life Sciences Industry.

The life sciences industry, broadly understood, comprise a wide array of complementary fields, the main ones of which are biotechnology and pharmaceuticals. Biotechnology is "the use of cellular and biomolecular processes to solve problems or make useful products."[3] In the field of

them available to American consumers to improve their health, to ensure their safety, to prolong their lives, to save their lives." Cong. Rec. S. 8850 (1997) (remarks of Sen. Coates, co-sponsor of the statute).

[3] BIOTECHNOLOGY INDUSTRY ORGANIZATION, EDITORS' AND REPORTERS' GUIDE 2004-2005 1 [hereinafter BIO GUIDE] available at http://www.bio.org/speeches/pubs; see also DEPARTMENT OF COMMERCE, A SURVEY OF THE USE OF BIOTECHNOLOGY IN U.S. INDUSTRY 3 (2003) [hereinafter COMMERCE BIOTECH SURVEY], available at

human health, to give a few examples, biotechnology companies produce medical diagnostic devices, such as gene probes, DNA markers, and new types of blood tests.[4] They also produce drugs and other therapeutics, such as vaccines, and "regenerative medicine" products, such as new proteins and antibodies.[5] Pharmaceutical companies make drugs to improve human health and treat an immense range of physical and mental illnesses.[6]

Both biotechnology and pharmaceutical companies run the gamut in size, from giants such as Amgen Inc. and Pfizer Inc. to small firms such as Corixa Corporation and Medicis Pharmaceutical Corporation.[7] Larger life sciences compa-

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http://www.usinfo.state.gov/usa/infousa/tech/biotech.html; STANDARD & POOR'S INDUSTRY SURVEY: BIOTECHNOLOGY 12 (2004) [hereinafter S&P BIOTECH SURVEY].

[4] COMMERCE BIOTECH SURVEY 26; BIO GUIDE 37-38; see also Acting FDA Commissioner Lester M. Crawford, Remarks at Pharmaceutical Research and Manufacturers of America Annual Meeting (Apr. 3, 2004) (discussing new medical advances), *available at* http://www.fda.gov/oc/speeches/2004/phrma0403.html.

[5] COMMERCE BIOTECH SURVEY 26; BIO GUIDE 38-44.

[6] STANDARD & POOR'S INDUSTRY SURVEYS, HEALTHCARE: PHARMACEUTICALS 11-15 (2004) [hereinafter S&P PHARMACEUTICALS SURVEY] (discussing drugs aimed at treating, among other diseases, depression, multiple sclerosis, and diabetes); see also PHARMACEUTICAL RESEARCH AND MANUFACTURERS OF AMERICA, PHARMACEUTICAL INDUSTRY PROFILE 2004, at 10-16 [hereinafter PHRMA PROFILE] (discussing new drugs for treating AIDS and Alzheimer's), *available at* http://www.phrma.org/publications.

[7] Amgen is the world's largest biotechnology company, with more than $5 billion in revenue in 2003 and nearly 13,000 employees; among other things, Amgen uses cellular biology to treat cancer. See http://www.amgen.com; S&P BIOTECH SURVEY 1-5, 7-9 (discussing Amgen drugs and its financial performance). Pfizer is the world's largest pharmaceutical company, number 25 in the Fortune 500, with more than $45 billion in revenue in 2003 and 122,000 employees worldwide; its best known products include Zoloft, for depression, and Lipitor, for high cholesterol.

nies have been turning more and more to smaller biotechnology firms to supplement in-house research and development efforts.[8] In particular, the smaller biotechnology firms are performing much of the important research and development in the industry today.[9] Once a small company identifies a promising prospect, a large company can provide it with

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See http://www.pfizer.com/are/mn_about_company.html; see also S&P PHARMACEUTICALS SURVEY 7-15 (discussing some of Pfizer's drugs), 7, 34-38 (financial performance).

Other companies are much smaller, though no less key. Corixa, for example, had about $13 million in revenue for the first half of 2004 and employs 380 people. It uses biotechnology in immunotherapy and has one drug currently on the market. See http://www.corixa.com. Medicis, which specializes in dermatological drugs, had $88 million in revenue for its most recent fiscal year and employs 300. See http:// www.medicis.com.

[8] See generally Arti Rai, *Fostering Cumulative Innovation in the Biopharmaceutical Industry*, 16 BERKELEY TECH. L.J. 813, 814-20 (2001) (discussing the numerous "strategic alliances" between biotech and pharmaceutical firms).

[9] See, *e.g.*, S&P PHARMACEUTICALS SURVEY 3, 25 (noting that "[m]ajor pharmaceutical companies are redoubling their efforts in developing new products by forming marketing and development alliances with . . . smaller biotechnology companies."); S&P BIOTECH SURVEY 16 ("New collaborative agreements have risen steadily in recent years, as Big Parma (large-capitalization pharmaceutical firms) and major biotechs have come to realize the scientific and economic benefits of partnerships with smaller biotech firms."); U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, PHARMACEUTICAL R&D: COSTS, RISKS, AND REWARDS 10 n.9 (1993) (noting that smaller biotechnology companies seek financial funding from pharmaceutical companies when other funding sources are not available), 1131 (describing pharmaceutical companies multi-tiered approach to research and development, which includes collaborations with specialized biotechnology companies, in addition to in-house research); see also *On the Mend; Biotechnology*, THE ECONOMIST, May 15, 2004, at 60 ("[Biotechnology companies'] productivity is reflected in lucrative deals with big drugmakers which are struggling to fill their own sluggish R&D pipelines.").

money for research and development and other costs, as well as an experienced sales force and production facilities.[10]

B. The Life Sciences Industry Is Fraught with Risk.

The life sciences industry is characterized by an extraordinarily high level of risk. The industry is predicated upon science — a constantly evolving process of exploration, experimentation, and discovery. By its very nature, science often produces incomplete, inconsistent, or unexpected results. As a result, the discovery of useful, marketable compounds is rare. Tellingly, only one of every 5,000 discovered compounds ultimately becomes a marketable drug.[11]

And life sciences companies seeking approval of their products must complete the rigorous clinical trial process

[10] See S&P BIOTECH SURVEY 8, 15-16; S&P PHARMACEUTICALS SURVEY 3, 25. In 2003, these partnership deals totaled nearly $10 billion. *Id.* at 16. Corixa is illustrative. It has reached agreements with over a dozen large drugmakers, and developed its one drug now on the market in a partnership with GlaxoSmithKline. See http://www.corixa.com.

[11] S&P PHARMACEUTICALS SURVEY 18 ("Financially, drug-manufacturing is a high-risk business"); Julia Hannah, *The Business of Biotech, Between the Lab and the Boardroom, Biotech Companies Seek Success in a Future of Dizzying Possibilities*, HARV. BUS. SCH. BULLETIN, June 2004 ("In biotech, one big drug will make you very profitable for a long time, but the percentage of drugs that make it to market is so low that it remains a risky proposition.") (quoting Professor Gary P. Pisano), *available at* http://www.alumni.hbs.edu/bulletin/2000/june/biotech.html; CALIFORNIA HEALTHCARE INSTITUTE, BIOMEDICINE: THE NEW PILLAR IN NORTHERN CALIFORNIA'S ECONOMY 14 (2002) ("But because scientific discovery and medical innovation require experimentation, and each step in bringing new products to market is tightly regulated by the government, biotechnology R&D in Northern California, as elsewhere, is a risky, lengthy and costly business."), *available at* http://www.pwc.com/technology/lifesciences/CA%20Biomed%20R&D %20 Survey%202002_NORTHERN%20 CAL.pdf.

required by the Food and Drug Administration ("FDA"). The process takes years to complete and comes with a high likelihood of failure. And it begins only after years of expensive and time-consuming laboratory and animal preclinical testing.[12] At each stage of the clinical trial process, failure or negative results are likely.

The FDA-regulated clinical trial process generally has three phases. Phase I involves the preliminary testing of a new product on humans.[13] Only approximately 70 out of every 100 drugs beginning human clinical trials complete Phase I.[14] Where results indicate that further study is safe, Phase II testing can proceed. Phase II clinical trials involve months or even years of safety and efficacy testing.[15] If Phase II data indicates that the product is safe and that it provides "preliminary evidence suggesting effectiveness of the drug,"[16] the FDA will authorize a comprehensive Phase III clinical trial.[17] Only 33 out of every 100 drugs tested on humans complete Phase II.[18]

[12] See generally S&P BIOTECH SURVEY 18-20 (summarizing regulatory process).

[13] See 21 C.F.R. § 312.21(a)(1)-(2). See generally CENTER FOR DRUG EVALUATION RESEARCH, UNITED STATES FOOD & DRUG ADMINISTRATION, CDER HANDBOOK 8 (1998) [hereinafter CDER HANDBOOK].

[14] See CENTER FOR DRUG EVALUATION RESEARCH, UNITED STATES FOOD & DRUG ADMINISTRATION, FROM TEST TUBE TO PATIENT: IMPROVING HEALTH THROUGH HUMAN DRUGS 22 (1999) [hereinafter TEST TUBE TO PATIENT], *available at* http://www.fda.gov/fdac/special/newdrug/ndd_toc.html.

[15] See 21 C.F.R. § 312.21(b).

[16] See *id.*

[17] See CDER HANDBOOK 10.

[18] See TEST TUBE TO PATIENT 21.

Phase III clinical trials are an even more significant undertaking; they often involve years of safety, efficacy, and dosage testing on hundreds and often thousands of patients.[19] The costs associated with Phase III clinical studies are staggering, running well into the million of dollars per drug.[20] And only 20-25% of drugs that begin human testing complete Phase III.[21] At the conclusion of a successful Phase III study, the sponsoring drug company still must submit a New Drug Application to the FDA.[22] In the end, only 20% of the products that begin the FDA clinical process in Phase I ultimately receive FDA approval.[23]

Even if a life sciences company gains FDA approval for a candidate, it faces further risks and uncertainties in commercializing the product. Companies wholly dedicated to developing a product must shift focus to concentrate on production, marketing, and distribution. Smaller companies often do not have these capabilities, so they must enter into partnering agreements with larger companies. The product manufacturing process is highly regulated and regimented. The manner in which a drug is advertised and marketed is also highly regulated. Each of these difficult steps involves some degree of risk of failure and reduces the likelihood that a drug will ever be a commercial success. Indeed, only one out of three drugs approved by the FDA generates a financial

[19] See 21 C.F.R. § 312.21(c).

[20] See Symposium, *Financing the Biotech Industry: Can the Risks Be Reduced?*, 4 B.U. J. Sci. & Tech. L. 1, 86 n.208 (1998) (noting that Phase III trials can cost from $1 million to $20 million).

[21] See TEST TUBE TO PATIENT 21.

[22] See 21 U.S.C. § 355(b); 21 C.F.R. § 314.50.

[23] See TEST TUBE TO PATIENT 35; see also http://www.fda.gov/fdac/special//newdrug/testtabl.html; PHRMA PROFILE 2-3; Joseph A. DiMasi et al., *Cost of Innovation in the Pharmaceutical Industry*, 10 J. HEALTH & ECON. 107, 124 (1991).

return sufficient to cover the costs of its own research and development.[24]

C. The Life Sciences Industry Is a Breeding Ground for Securities Fraud Class Actions.

Because the product life cycle is fraught with risk of failure or negative results, publicly-traded life sciences companies face great potential for adverse market events. When a company, particularly a smaller one, makes a negative announcement, the market typically reacts, the stock price declines, and the class action bar swings into action. No matter the cause of the market event, the response is usually a deluge of securities fraud class actions asserting boilerplate allegations that the company "fraudulently concealed" whatever facts led to the stock price decline, and that the "truth" was only later revealed with the bad news. The life sciences industry is facing a litigation crisis — a "growing, malignant phenomenon" that is hampering the discovery of life-saving remedies.[25]

The numbers bear this out. In 2003, securities fraud actions against life sciences companies increased by 39% from 2002.[26] And the number of securities class actions brought

[24] S&P PHARMACEUTICAL SURVEY 18.

[25] Bernadette Tansey, *Rise in Biotech Lawsuits, Industry Blames Law Firms Looking for New Targets, But Some Investors Claim Companies Misled Them*, SAN FRAN. CHRONICLE, Jan. 26, 2004, at E1 (quoting Carl Feldbaum, President of Biotechnology Industry Organization).

[26] See MICHAEL L. KICHLINE & DAVID A. KOTLER, DECHERT SURVEY OF SECURITIES FRAUD CLASS ACTIONS BROUGHT AGAINST LIFE SCIENCES COMPANIES 3 (2004) [hereinafter CLASS ACTION SURVEY], *available at* http://www.dechert.com/eventspubs/eventspubs.jsp?pg=lawyer_pubications_detail&id=4477. The underlying numbers for the survey are derived from the listing of class action complaint filings posted on the Stanford Clearinghouse website, *available at* http://securities.stan-ford.edu; see also PRICEWATERHOUSECOOPERS LLP, 2003 PRICEWATERHOUSECOOP-

against life sciences companies also increased as a percentage of overall securities fraud class actions. While life sciences companies were defendants in only 9% of all securities fraud class actions in 2002, that number rose to 15% in 2003.[27] *All* of the class actions filed in 2003 and 2004 against life sciences companies involve fraud-on-the-market claims.

The filings against life sciences companies are alarming not only in number, but in breadth of subject matter as well. These lawsuits typically allege misrepresentations and/or non-disclosures regarding product efficacy, product safety, clinical trial results, the FDA approval process, the quality of manufacturing processes, commercial alliances, marketing and advertising activities, and faulty accounting and/or finances.[28] Virtually every aspect of the business — from development to production to marketing to commercialization — is under attack.

D. Securities Fraud Class Actions Pose a Serious Threat to Life Sciences Companies.

The rising number of securities fraud class actions poses grave risks to the industry and, accordingly, the nation. While it is inevitable that companies in the industry will face litigation, including securities litigation, the industry cannot afford to divert its already limited and strained resources to defend baseless lawsuits. For this reason, ensuring that meritless complaints are dismissed at the pleading stage is critically important.

ERS SECURITIES LITIGATION STUDY 5 (2004) (noting that one "emerging trend" is "securities litigation against pharmaceutical companies"), *available at* http://www.10b5.com.

[27] CLASS ACTION SURVEY 3.

[28] *Id.* at 4-6.

1. The Depletion of Capital.

The life sciences industry is capital intensive. Biotechnology segments of companies spend more capital as a percentage of net sales than do non-biotechnology segments, and capital expenditures are higher per employee.[29] Research and development costs are also high. Biotechnology firms spend more as a percentage of total research and development expenditures in the United States than do the aerospace, machinery, or chemical industries.[30] In 2002 alone, biotechnology companies spent more than $20 billion on research and development.[31] Research and development "intensity" — the ratio of research and development spending to net sales — was eight times higher for biotechnology companies than the average U.S. business.[32] In the pharmaceutical world, capital is just as critical. Developing a new drug costs more than $800 million on average — and capital costs have increased in recent years 7% faster than inflation.[33]

The industry's critical reliance on capital, particularly with regard to the smaller developmental stage companies that generate little to no revenue, is one reason that the increase of securities fraud class actions filed against life sciences companies is so dangerous. These suits sap capital. The cost of defending a securities class action lawsuit is substantial, and a recent survey reports that the median

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[29] COMMERCE BIOTECH SURVEY 72.

[30] *Id.* at 73.

[31] BIO GUIDE 3.

[32] COMMERCE BIOTECH SURVEY 73.

[33] Joseph A. DiMasi, et al., *The Price of Innovation: New Estimates of Drug Development Costs*, 22 J. OF HEALTH ECON. 151, 166-68 (2003).

settlement amount is over $6 million while the average is approximately $20 million.[34]

2. The Impact on Scientists and Researchers.

The life sciences industry relies on uniquely qualified scientists, doctors, and researchers. The research and development process for new life sciences products is, by its nature, cutting-edge work, and correspondingly requires highly talented and skilled people. These individuals also must be "insightful and quick-thinking individuals," with the skills to manage.[35] They must not only be at the top of their area of science or medicine but also possess the knowledge and experience to successfully develop and commercialize a product, to manage research teams, and to handle ever more complex regulatory relationships.[36]

In a foreboding new trend, however, the securities fraud complaints against life sciences companies have gone beyond naming chief executives or other high ranking business people, the traditional defendants in securities fraud cases. Class action lawyers are now suing some of the most critical members of the industry's workforce — the scientists, researchers, and medical personnel that manage much of the industry's vital research and development.[37]

[34] Cornerstone Research, POST-REFORM ACT SECURITIES LAWSUITS, THE SETTLEMENTS REPORTED THROUGH DECEMBER 2003 2, *available at* securities.stanford.edu/Settlements/REVIEW_1995-2003/2003_Settlements _Release.pdf.

[35] S&P BIOTECHNOLOGY SURVEY 24; Julia Hannah, *The Business of Biotech, Between the Lab and the Boardroom, Biotech Companies Seek Success in a Future of Dizzying Possibilities*, HARV. BUS. SCH. BULLETIN, June 2002 ("'Once you attract bright, young scientists . . . you need to get them to realize this is not a postdoc lab, this is a business. It's not enough just to do the experiment; somebody's got to take the ball and run with it.'") (quoting Professor Gary P. Pisano of the Harvard Business School).

[36] S&P BIOTECH SURVEY 24-25.

3. The Distraction from Scientific Discovery.

Financial capital and human talent are only two of the key ingredients to the success of a life sciences company. The company must focus these resources on the scientific exploration needed to yield life-saving or life-enhancing products. This process can produce successful results only if it is supported and driven by an institutional, company-wide focus on achieving the company's core developmental objectives.

This is particularly so with the smaller biotechnology companies. In 2003, nearly half of the life sciences defen-

[37] See, *e.g.*, *Colandrea* v. *IntraBiotics Pharm., Inc.*, No. 04-CV-2675 (N.D. Cal. filed July 2, 2004) (naming "Senior Vice President of Pre-Clinical and Clinical Research and Development and Chief Medical Officer"); *Greater Pa. Carpenters Pension Fund* v. *Adolor Corp.*, No. 04-CV-1728 (E.D. Pa. filed Apr. 21, 2004) (naming "Vice President, Clinical Research and Development" and "Senior Vice-President, Research and Development"); *Maitland* v. *Genta, Inc.*, No. 04-CV-2123 (D.N.J. filed May 4, 2004) (naming "President, Pharmaceutical Development and Chief Medical Officer"); *Paragamian* v. *Vicuron Pharm., Inc.*, No. 04-CV-2627 (E.D. Pa. filed June 15, 2004) (naming "Chief Medical Officer"); *Smith* v. *Vaso Active Pharm., Inc.*, No. 04-CV-10708 (D. Mass. filed Apr. 8, 2004) (naming "Chief Scientific Officer"); *Adler* v. *Noven Pharm., Inc.*, No 03-22320 (S.D. Fla. filed Aug. 29, 2003) (naming "Chief Technical Officer"); *City of Dearborn Heights Gen. Govt. Employees' Retirement Sys.* v. *Vertex Pharm., Inc.*, No. 03-CV-11855 (D. Mass. filed Sept. 23, 2003) (naming "Chief Technology Officer" and "Senior Vice President, Drug Evaluation and Approval"); *Phillips* v. *Regneron Pharm.*, No. 03-3111 (S.D.N.Y. filed May 2, 2003) (naming "Chief Scientific Officer" and "Vice-President of Clinical Studies"); *Price* v. *Transkaryotic Therapies, Inc.*, No. 03-CV-10165 (D. Mass. filed Jan. 24, 2004) (naming "Chief Scientific Officer and Chairman of the Scientific Advisory Board"). These complaints can be viewed at http://securities.stanford.edu/companies.html.

dants had market capitalizations of less than $500 million.[38] And more than twenty percent had market capitalizations of less than $100 million.[39] Many of these companies generate little revenue and focus on developing only one or two products. Their staffing is lean, averaging fewer than 320 employees, with several companies having fewer than 200 or even 100 employees.

For instance: one of the smaller biotechs that has been sued is VaxGen, Inc. VaxGen has a current market capitalization of approximately $260 million and only 133 employees.[40] Its initial focus was on developing a vaccine for HIV. When the company announced apparently disappointing Phase III clinical trial results, it was sued in several securities fraud class actions.[41] VaxGen has since shifted its priorities away from the HIV vaccine to the development of other vaccines (to combat bioterrorism)[42] but remains saddled with the cost and distraction of the class actions. As VaxGen was forced to warn investors in its SEC filings: "These lawsuits could also result in continued diversion of our time and attention away from business operations, which could harm our business."[43]

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[38] CLASS ACTION SURVEY 3.

[39] *Id.*

[40] VAXGEN, INC., FORM 10-K ANN. REP. PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DEC. 31, 2003, 15 [hereinafter VAXGEN ANNUAL REPORT] (2004), *available at* http://ir.10kwizard.com/contents.php?ipage=2701872&repo=tenk&source=873.

[41] See *Whitkens* v. *VaxGen, Inc.*, No. C-03-1129-JSW (N.D. Cal. filed Mar. 17, 2003).

[42] See generally http://www.vaxgen.com.

[43] VAXGEN ANNUAL REPORT 27.

SUMMARY OF ARGUMENT

The Private Securities Litigation Reform Act of 1995 ("Reform Act") was Congress's response to, among other abuses, class action lawyers' maneuver of seizing upon the expense and disruption of discovery to exact unwarranted settlements. Congress's answer to this abusive tactic was to appoint the district courts as gatekeepers to the discovery process. Congress thus required courts to stay discovery once a defendant moved to dismiss a securities fraud class action complaint. Congress also heightened and supplemented the standards for pleading a securities fraud claim. This included the statutory codification of "loss causation" as an element of a Rule 10b-5 claim. Loss causation requires plaintiffs to plead and prove that their loss was directly caused by the misrepresentation, not simply that the plaintiffs entered into the challenged transaction because of the misrepresentation (transaction causation).

The Ninth Circuit's decision reads loss causation out of the Reform Act and, as a consequence, contravenes the Congressional mandate that the district courts serve as gatekeepers. The Ninth Circuit required that the plaintiff allege only that the misrepresentation artificially inflated the stock price at the time of purchase and expressly rejected the need to allege that a corrective disclosure later removed the artificial price inflation. That decision not only is wholly inconsistent with the words and intent of the Reform Act, but it also invites potential windfall damages awards for plaintiffs who sell or continue to hold the security before the artificial inflation is removed. It also improperly extends the presumption under the fraud-on-the-market theory, which this Court limited to reliance in *Basic, Inc.* v. *Levinson*, 485 U.S. 224 (1988), to loss causation.

The correct — indeed, Congressionally mandated — pleading standard for loss causation on a Rule 10b-5 claim is

this: A plaintiff must allege a corrective disclosure — that is, an announcement or other action that revealed the misrepresentation, thereby causing the efficient market to remove the artificial price inflation. This rule, not the Ninth Circuit's holding, is faithful to Congress's decision to establish "loss causation" as an element of a Rule 10b-5 claim. It requires that the misrepresentation be directly linked to an actual loss for which the plaintiff can recover. This test comports with the Reform Act and this Court's decision in *Basic*.

And, of particular importance to a life sciences company such as Petitioner, reversing the Ninth Circuit's decision will ensure that meritless suits are properly dismissed at the pleading stage. The life sciences industry seeks to develop products vital to everyday existence. It is a capital intensive industry, always struggling to raise capital and find the rare, highly skilled people who can conduct its research and development. The availability of capital, its cost, and the availability of qualified personnel cannot be left to the whims and profit motives of class action lawyers looking to exact undeserved settlements.

ARGUMENT

I. CONGRESS ESTABLISHED THE MOTION TO DISMISS STAGE IN A SECURITIES FRAUD CLASS ACTION AS A DEFINING POINT AT WHICH COURTS ARE TO ACT AS GATEKEEPERS.

Congress enacted the Reform Act to remedy wide-ranging abuses of the securities fraud class action process. The Reform Act contained sweeping remedies for those abuses, including heightened and supplemented pleading standards, a required stay of discovery pending a motion to dismiss, a requirement that lead plaintiffs, not just lawyers, have a strong financial interest in the litigation, and a required review of the plaintiffs' lawyers' compliance with

their obligations under Fed. R. Civ. P. 11(b). See 15 U.S.C. § 78u-4(b).

Foremost among Congress's concerns were abuses of the discovery process to force defendants into settlements.[44] As the Senate Committee on Banking, Housing and Urban Affairs put it, the "cost of discovery often forces defendants to settle abusive securities class actions. . . . In addition, the threat that the time of key employees will be spent responding to discovery requests, such as providing deposition testimony, may force coercive settlements."[45] Congress was particularly concerned that these securities class actions were settling for reasons other than the merits:

> The settlement value to defendants turns more on the expected costs of defense than the merits of the underlying claim. . . . If a defendant cannot win an early dismissal of the case, the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial.[46]

This Court has expressed the same concerns regarding securities "strike suits," particularly with regard to discovery abuses:

> [T]o the extent that it permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the

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[44] See H.R. Conf. Rep. No. 104-369, at 31 (1995) (citing abuse of the "discovery process to impose costs so burdensome that it is often economical for the victimized party to settle").

[45] S. Rep. No. 104-98, at 14 (1995).

[46] *Id.* at 6-7; see also H.R. Conf. Rep. No. 104-369, at 37 ("The cost of discovery often forces innocent parties to settle frivolous securities class actions.").

> right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonable founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit.

Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723, 741 (1975); see also *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994) (recognizing "danger of vexatiousness different in degree and in kind from that which accompanies litigation in general").

To curb the coercive effect of these discovery abuses, Congress established the motion to dismiss as a defining point in securities fraud class action litigation. It accomplished this in two ways.

First, it appointed the federal courts as gatekeepers to the discovery process, requiring courts to stay "all discovery" in a securities class action pending a defendant's motion to dismiss the complaint. See 15 U.S.C. § 78u-4(b)(3)(B). With this, Congress ensured that class action lawyers could not wield the expense and disruption of discovery as a weapon to coerce a settlement without first having shown that they filed a legally sufficient complaint.[47]

Second, in the same subsection in which it required courts to stay discovery, the Reform Act supplemented and heightened the pleading requirements to be enforced on a motion to dismiss. It did so by requiring securities fraud plaintiffs to plead facts "giving rise to a strong inference" of scienter, a longstanding element of a Rule 10b-5 claim, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 201 (1976), and by

[47] S. Rep. No. 104-98, at 4, 14 ("discovery should be permitted in securities class actions only after the court has sustained the legal sufficiency of the complaint").

requiring plaintiffs to plead any alleged misstatements or omissions with specificity, including the reasons why they were misleading. See 15 U.S.C. § 78u-4(b)(1) & (2).

Congress also supplemented the pleading requirements, again in that same subsection, by requiring securities plaintiffs to plead and prove loss causation: "Loss causation. — In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). The report from the managers of the House and Senate made clear that plaintiffs must "plead" this element.[48] The Senate Committee further confirmed that this was an added pleading requirement, as its report discussed the addition of loss causation in the section entitled "A strong pleading requirement."[49]

Loss causation is peculiar to Rule 10b-5 litigation. It provides that a plaintiff can recover only if the alleged economic loss is directly linked to the falsity of the alleged misrepresentation. See *Emergent Capital Inv. Mgmt., LLC* v. *Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) (holding that loss causation is the connection "between the alleged misconduct and the economic harm ultimately suffered by the plaintiff."); *Robbins* v. *Koger Props., Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997) ("[L]oss causation describes the link between the defendant's misconduct and the plaintiff's economic loss."). The Senate Committee explained that loss causation requires plaintiffs to show "that the loss in the value of their stock was caused by the Section 10(b) violation and not other factors."[50] This comports with

[48] See H.R. Conf. Rep. No. 104-369, at 41.

[49] S. Rep. No. 104-98, at 15.

[50] *Id.* at 7.

the definition used in a related section of the Reform Act, which established loss causation as an element of a claim under the Securities Act of 1933, stating that it restricts recoverable damages to only those that result from the falsity of the misstatement, and not from other factors. See 15 U.S.C. § 77l(b).

A related, though different, element in a Rule 10b-5 claim is "transaction causation." Transaction causation is akin to "but for" causation in the common law. It requires that the plaintiff show that he or she would not have entered into the challenged transaction "but for" the defendant's fraud. *Emergent*, 343 F.3d at 197 ("[Transaction causation] is established simply by showing that, but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction."). Courts have often used "transaction causation" and "reliance" interchangeably. See *id.* ("Like reliance, transaction causation refers to the causal link between the defendant's misconduct and the plaintiff's decision to buy or sell securities."); *Robbins*, 116 F.3d at 1447 ("Transaction causation, another way of describing reliance, is established when the misrepresentation or omissions cause the plaintiff to engage in the transaction in question.") (internal quotations omitted); *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) (treating the reliance element of a Rule 10b-5 claim as transaction causation).

The Congressionally mandated element of loss causation plays an important role in determining whether a plaintiff is seeking the type of damages authorized by Congress. As discussed below, the Ninth Circuit's decision improperly abandons this requirement.

II. THE NINTH CIRCUIT'S DECISION WOULD IMPERMISSIBLY READ LOSS CAUSATION OUT OF RULE 10B-5 FRAUD-ON-THE-MARKET CLAIMS AND WOULD FRUSTRATE THE GATEKEEPING FUNCTION.

The Ninth Circuit's decision runs counter to what Congress sought to achieve by passing the Reform Act. It creates a definition of loss causation that is little more than "transaction causation" (or reliance), and then presumes it away under the fraud-on the-market theory. But by not requiring plaintiffs who invoke the fraud-on-the-market theory to plead a corrective disclosure — that is, a disclosure that removed the artificial inflation in the security's market price — the Ninth Circuit improperly relieves plaintiffs of the Congressionally mandated requirement to plead a direct causal link between the falsity of the misrepresentation and the loss.

A. The Ninth Circuit's Flawed Definition of Loss Causation Would Result in Windfall Damages and Render It Meaningless in Rule 10b-5 Fraud-on-the-Market Claims.

The Ninth Circuit's definition of loss causation requires only that a plaintiff plead that the security's "price at the time of the purchase was overstated." Pet. App. at 9a. In other words, it focuses solely on inflation of the market price at the time that the plaintiff purchased the security rather than any loss that the plaintiff may have suffered once that artificial inflation was removed.

In a fraud-on-the-market case, where a plaintiff is invoking and relying upon an efficient market, this definition's fundamental flaw is that the artificial price inflation must actually be removed before a plaintiff can suffer a compensable loss. The very presumption that underlies the fraud-on-the-market theory is that the security trades on an efficient market. *Basic*, 485 U.S. at 246 ("Recent empirical

studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."); *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 178 (3d Cir. 2000) (noting that "[u]nder the fraud on the market theory of reliance, the court presumes . . . that the market price of the security actually incorporated the allege misrepresentations"). Thus, if a corrective disclosure has not been made, the market price will continue to hold the artificial inflation. Plaintiffs who still hold the stock can simply resell the stock and recoup the artificial inflation that they initially overpaid. And plaintiffs who have already sold their stock have already recouped the artificial inflation. Awarding any of these plaintiffs damages would provide them with an undeserved windfall.

The practical effect of the Ninth Circuit's definition is to render loss causation meaningless in fraud-on-the-market cases. In *Basic*, this Court approved the fraud-on-the-market theory. 485 U.S. at 241-48. It authorized the use of the efficient market hypothesis to presume that a plaintiff, rather than relying on a specific material misrepresentation, relied on the efficient market to incorporate all material information, including the misrepresentation, into the market price. *Id.* This removed the barrier that individual reliance issues had posed to Rule 10b-5 class actions and allowed plaintiffs' lawyers to bring large class actions.[51] *Id.* at 242.

But the *Basic* decision authorized the presumption of reliance, and no more. It explicitly framed the question before it as "whether it was proper for the courts below to apply a

[51] Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of* Basic v. Levinson, 77 VA. L. REV. 1017, 1020 n.9 (1991) (noting that "the traditional reliance requirement [wa]s a particularly difficult hurdle for plaintiffs in class action law suits" before *Basic*).

rebuttable presumption of *reliance*, supported in part by the fraud-on-the-market theory." *Id.* (emphasis added). It then determined that, "[b]ecause most publicly available information is reflected in market price, an investor's *reliance* on any public material misrepresentations, therefore, *may be presumed* for purposes of a Rule 10b-5 action." *Id.* at 247 (emphasis added). *Basic* made no mention of presuming any other element of a Rule 10b-5 claim. See *Robbins*, 116 F.3d at 1448 ("But the fraud on the market theory, as articulated by the Supreme Court, is used to support a rebuttable presumption of reliance, not a presumption of causation.").

The Ninth Circuit's decision, however, improperly extends the *Basic* presumption to loss causation. A Rule 10b-5 fraud-on-the-market plaintiff would be required to plead no more than the elements that it was required to plead before Congress passed the Reform Act. A Rule 10b-5 plaintiff following the Ninth Circuit's definition would need to plead only a material misrepresentation, a longstanding element of a Rule 10b-5 claim, and the efficient market would then be presumed to incorporate that material misrepresentation into the security's price, thereby artificially inflating it. *Basic*, 485 U.S. at 246. Since this artificial inflation satisfies the Ninth Circuit's definition of loss causation, the efficient market theory would therefore presume not only reliance (or transaction causation), but also loss causation.

Not only does this extend *Basic* well beyond its own plain terms, it renders meaningless Congress's decision to codify loss causation as a distinct element of a Rule 10b-5 claim. Under a basic canon of statutory construction courts may not interpret a statutory provision so as to render any part meaningless or superfluous. *E.g.*, *Astoria Fed. Sav. & Loan Ass'n* v. *Solimino*, 501 U.S. 104, 112 (1991) ("[W]e construe statutes, where possible, so as to avoid rendering superfluous any parts thereof."); *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 339 (1979) ("In construing a statute we are

obliged to give effect, if possible, to every word Congress used.").

B. A Rule 10b-5 Plaintiff Who Invokes the Fraud-on-the-Market Presumption Is Required to Plead a Corrective Disclosure.

To plead loss causation in a fraud-on-the-market case, a plaintiff is required to plead that a corrective disclosure or disclosures removed the artificial inflation from the market price of the security and thereby caused an economic loss. See *Semerenko*, 223 F.3d at 185 ("In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price."); *Robbins*, 116 F.3d at 1448 ("In fact, the claims presented to the jury do not attempt to link [the defendant's] misrepresentations to any decline in the value of plaintiffs' investment. Instead, plaintiffs simply claim they paid too much. But there is no evidence that this price inflation was removed from the market price of [the stock], causing plaintiffs a loss."). This allegation, and not an allegation that the material misrepresentation inflated the price, provides the required link between the falsity of the misrepresentation and an actual, recoverable loss. It also ensures that a plaintiff cannot seek windfall damages.

The logic behind this requirement is fundamental. The efficient market hypothesis presumes that a well developed, efficient market will incorporate all material information into the security's market price. *Basic*, 485 U.S. at 246. Just as the misrepresentation would inflate the market price at the time of purchase (not a recoverable loss), the correction of the misrepresentation would be reflected in the market price, thereby removing the artificial price inflation. At this point, the investor incurs a legally cognizable loss.

A plaintiff should not be permitted to exploit the fraud-on-the-market theory to presume a required element and then ignore its logical effect on another necessary element. A plaintiff cannot plead fraud on the market halfway. If plaintiffs are permitted to use the fraud-on-the-market theory to presume reliance at the pleading stage, then they must accept that theory when it comes to establishing loss causation.

C. The Ninth Circuit's Decision Precludes Meaningful Review of Loss Causation at the Pleading Stage.

The Ninth Circuit's decision would frustrate the Reform Act's goal of requiring the federal courts to scrutinize the sufficiency of a complaint at the motion to dismiss stage. Under that decision, a plaintiff in the Ninth Circuit need only recite a boilerplate phrase — that the misrepresentations artificially inflated the security's price at the time of purchase. There would be no way for the district court to test the sufficiency of such an allegation on a motion to dismiss. The litigation then would be permitted to proceed to protracted discovery and a battle of the experts on, among others, the issue of price inflation. Requiring only the mere recitation of a boilerplate phrase is a meaningless exercise that increases the risk that meritless complaints will proceed to discovery, rather than decreasing that risk as Congress intended.

Requiring a plaintiff to plead a corrective disclosure as well as a material misrepresentation, on the other hand, enables the district court to provide the type of meaningful review that the Reform Act requires. If plaintiffs must plead specific misrepresentations and a corrective disclosure, the court can test whether the requisite nexus is alleged between the fraud and the loss. Complaints that fail this pleading test would be dismissed, while complaints that allege the required nexus (assuming other elements are met) would proceed. This pleading requirement allows the courts to ful-

fill their role as gatekeepers on a motion to dismiss — as Congress envisioned under the Reform Act.

III. THE NINTH CIRCUIT'S DECISION WOULD INCREASE THE RISK THAT MERITLESS CLASS ACTIONS WOULD BE PERMITTED TO PROCEED, WITH HARMFUL CONSEQUENCES TO THE LIFE SCIENCES INDUSTRY.

When Congress passed the Reform Act, it made clear that biotechnology companies were particularly susceptible to securities fraud class action lawsuits.[52] This has proved to be the case for biotechnology companies and the life sciences industry as a whole. Securities fraud class actions filed against life sciences companies have increased both in number and as a percentage of overall securities fraud class actions. See *supra* Background Section C. And every one of these actions filed in 2003 and 2004 involved fraud-on-the-market claims. *Id.* Class action lawyers are taking advantage of the very nature of the scientific work performed by life sciences companies, which produces more unsuccessful projects than successful ones, to file class actions alleging that companies somehow misled the public in the past, and that the truth was only revealed with the bad news. How courts handle their role as gatekeepers to the discovery process, therefore, will substantially impact the life sciences industry.

First, the Reform Act's legislative history makes clear that Congress sought to stop the increase in the "cost of raising capital" that is caused by securities class actions.[53] It

[52] See S. Rep. No. 104-98, at 5 (stating that "high-tech, bio-tech and other growth companies . . . are sued disproportionately in 10b-5 litigation").

[53] *Id.* at 4, 14.

also made clear that requiring loss causation would play an important role in this effort.[54] The unremarkable, but important, premise underlying this conclusion is that unnecessary litigation expense depletes capital and increases its cost.[55]

The life sciences industry is one of the most capital intensive industries operating today. See *supra* Background Section D, 1. Allowing meritless claims to proceed beyond the pleadings stage would force life sciences companies to re-route existing capital from vital research and development projects to finance their defense and fund unwarranted settlements.

Second, Congress also intended the Reform Act to prevent "baseless and extortionate securities lawsuits" from deterring qualified individuals from accepting key positions at public companies.[56] If anything, though, this problem has recently been exacerbated in the life sciences industry. Class action lawyers are now suing the scientists, doctors, and researchers that manage the industry's vital research and development efforts. See *supra* Background Section D, 2. In all, nearly 20% of the securities class action complaints

[54] *Id.* at 8 (stating that "provisions intended to reduce the cost of raising capital . . . include . . . codifying the requirement under current law that plaintiffs prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors").

[55] Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L. J. 945, 948 (1993) ("Unnecessary civil . . . liability diminishes the return to, and increases the cost of, capital.").

[56] H.R. Conf. Rep. No. 104-369, at 31-32 (noting the "unwillingness of the best qualified persons to serve on boards of directors"); see also Winter, *supra*, at 945 ("The second effect of unnecessary civil and criminal liability is that participants in the capital markets, including the intermediaries and managers, may be deterred from engaging in efficient conduct by the fear of such liability.").

filed against life sciences companies in 2003 and 2004 named such individuals.

This is a direct attack on life sciences industry's most important asset: highly trained, uniquely qualified individuals. Life sciences companies are constantly struggling to find personnel with the technical skills, educational level and management experience necessary to conduct and manage the type of innovative and difficult research and development that the life sciences industry must conduct.[57]

Third, Congress also sought to deter the filing of abusive lawsuits against small developmental stage companies: "Smaller start-up companies bear the brunt of abusive securities fraud lawsuits. Many of these companies are high-technology companies which, inherently have unpredictable business prospects and, consequently, volatile stock prices."[58]

These types of companies are particularly important in the life sciences industry. Developmental stage biotechnology companies more and more are performing the important and innovative research and development in the industry. See *supra* Background Section A. Yet these smaller firms are also at the center of the litigation crisis. Almost half of the securities class actions filed against life sciences companies in 2003 were filed against companies with less than $500 million in market capitalization. And more than twenty percent of those suits were filed against companies with a

[57] See, *e.g.*, *Large Drug Mergers IMPACT Entire Pharmaceutical Chain*, N.J. Bus. Feb. 1, 2003, at 14 (noting that "the number of pharmaceutical jobs will increase by 14,000 by Feb. 1, 2003," but that "companies will have a hard time finding enough qualified people for those high-skilled jobs").

[58] S. Rep. No. 104-98, at 9.

market capitalization of less than $100 million. See *supra* Background Section C.

These small companies are especially vulnerable to the expense and disruption of extortionate securities class action litigation. Many generate little to no revenues, and their operations are singularly reliant on capital infusions. They are generally leanly staffed and focused on the development of one or two products. See *supra* Background Section A. Securities fraud lawsuits drain capital and increase its cost to these companies. The dismissal and deterrence of meritless securities fraud class actions is vital to allowing these companies to retain their focus on developing potentially important products, instead of defending meritless securities fraud class actions.

CONCLUSION

For the foregoing reasons, the judgment of the Ninth Circuit should be reversed.

Respectfully submitted.

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